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JANUARY 2005 UPDATE OF THE CONVERGENCE PROGRAMME OF SLOVENIA (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

On 10 January 2005, Slovenia submitted the first update of its convergence programme, covering the period 2004-2007. A delay of six weeks was requested due to the change in government following the October 2004 parliamentary elections. The programme partly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[2]. In particular, government accounts still fail to fully abide by ESA95 standards as seen by the large share of "other" revenue and expenditure as percentage of GDP. Therefore, Slovenia is invited to achieve compliance with the data requirements.

The macro-economic scenario underlying the updated convergence programme has been revised upwards since the May 2004 convergence programme in light of the favourable developments in the domestic and international environment. Broadly in line with the Commission services autumn 2004 forecasts until 2006, the new scenario can be considered as plausible. Real GDP growth, hovering just below 4% throughout the programme period, assumes that the economy will remain resilient. The projected growth rates are close to potential growth consistent with the programme as calculated by Commission services on the basis of the commonly agreed methodology. Forecast to settle below 3.0% (in CPI terms) after 2005, the projection for inflation reveals rather favourable expectations of future price developments. The Commission services take a more cautious view of the disinflation process due to structural imperfections, particularly in the non-tradable sector, which keep inflation well above the EU-average.

The disinflation process came to a halt in May 2004 when the annual growth rate of HICP inflation bounced back to almost 4% after having decreased to 3.5% from January to March. The inflation spike was, according to the authorities, mainly due to higher oil prices and higher excise duties on tobacco. While year-on-year inflation returned to 3.4% by October, it picked up again in November to 3.8% as a result of higher food and fuel prices. On the back of lower inflation, short-term interest rates fell from 6 to 4%, while long-term interest rates declined from above 5% to less than 4%. On 28 June 2004, Slovenia joined the ERM II with a standard fluctuation band of ±15 percent around a central parity of 239.64 SIT/EUR. This ended a long period of continuous depreciation against the euro (at a pace of some 3-5% a year) and the tolar has remained very stable since then. The new government, which took office on 3 December 2004, has confirmed that adopting the euro at the beginning of 2007 is one of its central goals.

The updated convergence programme strives at achieving a budgetary position of close-to-balance but not during the programme period. The deficit halves over the next four years with a back-loaded adjustment profile. While no reduction is envisaged for 2005 – the general government deficit thus staying at the same level as in 2004 (2.1% of GDP) –

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[1] This technical analysis, which is based on information available up to 9 February 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 16 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Mateja Peternelj (Mateja.Peternelj@cec.eu.int).

[2] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

2006 should see the deficit decline to 1.8% of GDP, and further dropping to 1.1% in 2007. Compared to the previous programme, the deficit targets are ¼% of GDP higher in each year, reflecting a recent reclassification of two extra-budgetary funds into the general government sector. By 2007, the primary balance is expected to turn positive. Fiscal consolidation is projected to be channelled mostly through a cut in the expenditure ratio until 2006. However, the considerable reduction of the deficit foreseen in 2007 is exclusively due to a significant increase in the revenue ratio based on the assumption that Slovenia would be a net recipient from the EU budget in the amount of 0.8% of GDP, up from 0.4% of GDP assumed for 2005-2006. Overall, the consolidation path appears rather unambitious in setting the budgetary targets as the current update broadly confirms the planned adjustment in the previous programme against a slightly more favourable macroeconomic scenario.

The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, a plausible macroeconomic scenario supports the deficit targets. Furthermore, it is at government's discretion to refuse claims for further expenditure to safeguard the deficit target in case it is threatened by unfavourable conditions, as was done in 2004. In addition, the yearly loss of VAT revenue at 0.3% of GDP may be overestimated, implying that the tax revenue projections seem to err on the side of caution. On the other hand, the outcome for 2007 is partly due to the new EU financial perspective 2007-2013, anticipating a significant rise in the net budgetary inflows from the EU budget, to amount to 0.8% of GDP, up from 0.4% the year before. Moreover, there is a risk of expenditure overruns, particularly regarding pension outlays should the review of the current pension indexation formula, announced for 2006, lead to a loosening of the parameters.

In view of this risk assessment, the budgetary stance in the programme may not provide a sufficient safety margin to avoid a breach of the 3% of GDP deficit threshold with normal cyclical fluctuations throughout the programme period. In addition, it is not sufficient to achieve the Stability and Growth Pact's medium-term objective of a budgetary position of close-to-balance within the programme period.

Gross government debt is relatively low and will remain so over the programme period. In 2004, the debt is estimated to have risen to 30.2% of GDP. Based mainly on the stock-flow adjustment, the government foresees a further increase in the debt ratio in the next two years, peaking at 30.9% of GDP in 2006. By 2007, the debt is forecast to fall below 30% of GDP, reaching 29.7%, as a favourable stock-flow adjustment is anticipated. The authorities consider that there are no imminent risks to debt sustainability associated with contingent liabilities. Moreover, the maturity and currency structure of the debt portfolio are deemed appropriate since a long-term repayment profile spreads evenly over time with a growing share of tolar-denominated debt and external debt being predominantly euro-denominated.

The programme reviews the government's structural reform agenda which focuses on enhancing the competitiveness of the economy by encouraging entrepreneurship and increasing R&D expenditures in the budget. Currently accounting for 1.5% of GDP, the highest among the ten new member states, the share of public funding is to move closer to the EU average whereby policy action will particularly target the applied research projects and the transfer of know-how to the private sector. It also outlines measures to sustain economic growth, e.g. improving education and training as well as promoting job-creation oriented investment and removing structural rigidities in the labour market. Moreover, a number of measures have been designed so as to limit the high share of mandatory expenditure, which remains key to increasing fiscal flexibility. In the update of the convergence programme, the authorities have made an effort to quantify the impact of the planned reforms on the projections of the main fiscal aggregates. The overall effect of reducing and restructuring the general government expenditure has been estimated to result in savings, increasing from 0.4% of GDP to 1.3% of GDP by 2007.

Slovenia appears to be at some risk with regard to the long-term sustainability of the public finances, of which the projected budgetary cost of an ageing population is an important element. The ongoing pension reform has had a positive budgetary impact but the projected increase in pension expenditure beyond 2020 remains very high. In addition, despite the introduction of some rationalisation measures of the health-care system in 2004, a further, substantial reform of the health-care system would contribute to the improvement of the long-term sustainability of public finances.

In view of the above assessment, it would be appropriate for Slovenia to (i) seize all opportunities to accelerate the reduction of the general government deficit and to (ii) undertake further reform of the pension and health-care system to improve the long-term sustainability of the public finances.

Table: Comparison of key macroeconomic and budgetary projections

		2004	**2005**	**2006**	**2007**
Real GDP (% change)	**CP January 2005**	**4.0**	**3.8**	**3.9**	**4.0**
	COM October 2004	4.0	3.6	3.8	n.a.
	CP May 2004	*3.6*	*3.7*	*3.8*	*3.9*
HICP inflation (%)	**CP January 2005**[1]	**3.6**	**3.0**	**2.7**	**2.6**
	COM October 2004	3.9	3.4	3.0	n.a.
	CP May 2004[1]	*3.3*	*3.0*	*2.7*	*2.6*
General government balance (% of GDP)	**CP January 2005**	**-2.1**	**-2.1**	**-1.8**	**-1.1**
	COM October 2004	-2.3	-2.2	-1.9	n.a.
	CP May 2004	*-1.9*	*-1.8*	*-1.5*	*-0.9*
Primary balance (% of GDP)	**CP January 2005**	**-0.3**	**-0.4**	**-0.2**	**0.4**
	COM October 2004	-0.3	-0.2	-0.1	n.a.
	CP May 2004	*-0.3*	*-0.4*	*-0.2*	*0.4*
Government gross debt (% of GDP)	**CP January 2005**	**30.2**	**30.7**	**30.9**	**29.7**
	COM October 2004	30.9	30.8	30.6	n.a.
	CP May 2004	*29.1*	*29.5*	*29.4*	*28.4*

Note:
[1] CPI inflation for the convergence programmes
Sources:
Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM)

1. INTRODUCTION

The update of the Slovene convergence programme was submitted on 10 January 2005. A delay of six weeks was requested due to the change in government following the October 2004 parliamentary elections. The new government, in office since 3 December, approved the updated programme on 7 January but did not include the pending supplementary 2005 budget.

The programme sets out a medium-term fiscal policy framework for the period 2004-2007. It partly complies with the data requirements set out by the code of conduct. In particular, government accounts still fail to fully abide by ESA95 standards[3], while the table on external assumptions is missing[4]. The content and format of the document, on the other hand, largely adheres to the model structure proposed in the code of conduct.

2. MACROECONOMIC DEVELOPMENTS

The projections of the main macroeconomic aggregates have been revised upwards since the May 2004 convergence programme in light of the favourable developments at home and abroad. No major differences exist compared to the Commission services autumn 2004 forecasts. The new real GDP growth path with rates slightly below 4% appears plausible. Both consumption and investment spending are expected to accelerate further, supported by low interest rates and favourable loan conditions through the national housing saving scheme, which could swing the economy into a new expenditure cycle.[5] Investment in particular, is set to grow vigorously, following a boost in construction activity and production capacity adjustments, undertaken to meet revived foreign demand. With exports booming, the economic upturn should be steady and robust.

Throughout the programme period, real GDP is projected to grow at rates close to potential output growth estimated by Commission services according to the agreed methodology on the basis of the information in the programme. However, these figures are somewhat higher than those underlying the Commission services autumn 2004 forecasts, due to a higher contribution of labour in the programme.

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[3] The delimitation of general government has been refined as requested by Eurostat (see Box 1). However, accounting needs to be further improved in view of the high share of "other" revenue and expenditure as percentage of GDP (Table 2) although the programme, admittedly, clearly specifies the items included in "other expenditure". In addition, there is a minor discrepancy in the aggregation of the ratios of the components of government revenues. It is nevertheless noteworthy that the category "individual consumption expenditure" is now available as the spending breakdown was adjusted to distinguish between social benefits in kind and social benefits other than in kind.

[4] Although certain assumptions can be drawn from the text, some key compulsory data are missing, e.g. interest rates and growth in the rest of the world. However, this does not hamper the assessment.

[5] The national housing saving scheme is a 5-year saving facility, designed by the government to support new home ownership. With twelve regular monthly instalments an additional, 13th payment is taken in charge by the state housing fund each year. The principal augmented by interest is redeemable after five years. Furthermore, the saver is entitled to claim a loan equal to 2-2.5 times the principal offered at a subsidised interest rate. The first national housing saving scheme reached maturity in July 2004 and will be followed by other schemes over the next three years.

The external economic assumptions (insofar as they can be derived in the absence of the standard table) broadly correspond to those underlying the Commission services autumn 2004 forecasts. However, the oil price assumption of 37 US$ per barrel throughout the programme period is at the lower side of the projection range.[6] This entails a more favourable disinflation path in the programme. Having settled at 3.6% in 2004, as forecast, the average rate of CPI inflation is projected to decrease to below 3.0% from 2005 onwards. Measured in HICP terms, the Commission services autumn 2004 forecasts reflect a more cautious view on the lowering of inflation.[7] Bringing it down sustainably might prove to be challenging due to structural imperfections, particularly in the non-tradable sector, which keep inflation well above the EU-average.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Real GDP (% change)	4.0	4.0	3.6	3.8	3.8	3.9	4.0
Contributions:							
- Final domestic demand	4.2	4.4	4.0	4.4	4.1	3.8	4.1
- Change in inventories	0.6	0.3	0.5	0.1	0.5	0.2	0.0
- External balance on g&s	-1.1	-0.7	-0.9	-0.7	-0.8	-0.1	-0.1
Employment (% change)	0.2	0.4	0.4	0.3	0.4	0.4	0.5
Unemployment rate (%)	6.3	6.4	6.1	6.1	5.8	5.9	5.8
HICP inflation (%)[1]	3.9	3.6	3.4	3.0	3.0	2.7	2.6
GDP deflator (% change)	4.1	3.6	3.4	3.1	3.1	2.6	2.7
Current account (% of GDP)	-0.2	-0.2	-0.8	-0.4	-1.0	-0.4	-0.5

Note:
[1] The convergence programme projects CPI inflation.
Sources:
Commission services autumn 2004 economic forecasts (COM); convergence programme update (CP)

Table 2: Sources of potential output growth

	2004		2005		2006		2007
	COM	**CP[3]**	**COM**	**CP[3]**	**COM**	**CP[3]**	**CP[3]**
Potential GDP growth[1]	3.5	3.8	3.3	3.8	3.3	4.0	4.0
Contributions:							
- Labour	0.1	0.3	0.0	0.3	0.0	0.5	0.5
- Capital accumulation	2.4	2.4	2.3	2.4	2.3	2.3	2.3
- TFP	1.0	1.1	1.0	1.1	1.0	1.1	1.2
Output gap[1,2]	-0.9	-1.2	-0.6	-1.2	-0.1	-1.3	-1.3

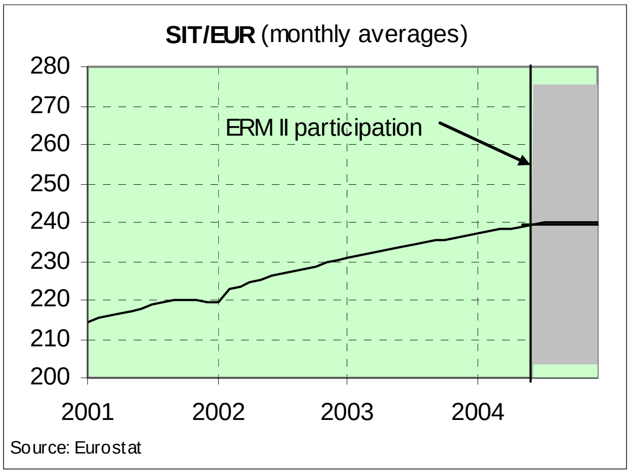
Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme (CP)

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

[6] A simulation in the convergence programme indicates that an increase in oil prices by 10 US$ per barrel – to test the impact of the much higher Commission services assumption, set at 45.1 US$ for 2005 – would propel inflation by 0.8 of a percentage point and lower economic growth by 0.3 of a percentage point.

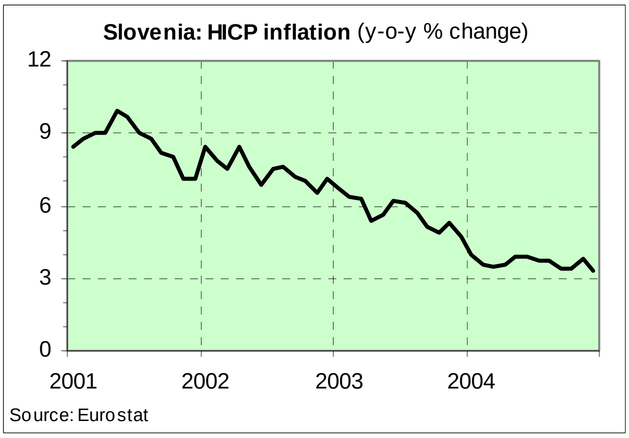
[7] The inflation record shows that the annual average HICP inflation has been consistently higher than the CPI inflation rate. In 2004, however, the difference was minor as the HICP inflation reached 3.7%, just 0.1 of a percentage point above the CPI inflation.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY



Slovenia joined ERM II on 28 June 2004 with a standard fluctuation band of ±15 percent band around a central parity of 239.64 SIT/EUR. The Slovene tolar has been very stable against the euro since its participation in ERM II. On a daily base, the average deviation has been 0.11 percent, while the maximum deviation from the central rate reached 0.16 percent.

After having been cut by 50 basis points on the first day of ERM II participation, the main refinancing rate displayed a constant spread of 100 basis points to the ECB's main refinancing rate until December, when it was raised by 25 basis points. In 2004, both money market and long-term interest rates decreased. Short interest rates fell from 6 percent to 4 percent, while long-term interest rates declined from above 5 percent to less than 4 percent. Long-term real interest rates declined and stood, in November, at their lowest level of the year at about 0.50 percent, on the back of falling inflation.



HICP inflation increased to 3.9 percent year-on-year in May 2004 after having already declined from 4.0 to 3.5 percent between January and March. The temporary inflation rebound was, according to the authorities, mainly due to higher oil prices and higher excise duties on tobacco. Year-on-year HICP inflation reached a year-low of 3.3 percent in December following the November spike to 3.8 percent as a result of higher food and fuel prices.

The authorities recognise that the room for independent monetary policy setting is limited. The programme acknowledges that other economic policies and, in particular, fiscal policy and wage policy have a greater role to play in achieving durable disinflation, which is the core challenge faced by the Slovene economy, as recognised in the communiqué establishing the tolar participation in ERM II.

The new government has confirmed that adopting the euro in early 2007 is one of its central goals.

4. BUDGETARY IMPLEMENTATION IN 2004

In 2004, the general government deficit is estimated to have inched up by 0.1 of a percentage point, as anticipated in the May 2004 convergence programme, to reach 2.1% of GDP. This preliminary outcome exactly corresponds to the previous target of 1.9% adjusted for a revision of government accounts, linked to the sectoral re-classification of some public institutions (see Box 1). The budgetary position, however, is worse than targeted initially in the 2004 budget (1.6% of GDP according to the 2003 pre-accession economic programme).

According to the preliminary outcome, the loss in VAT resources following the dismantling of border controls (and replacing them with the EU declaration system which is regarded as "less efficient" by the authorities) was substantially larger than budgeted. Furthermore, in September excise duties on fuel were set at the lowest level permitted by the EU to offset the negative consequences of the oil price hike on inflation.[8] In October, when the revenue shortfall approached the threshold set in the Implementation Bill to the 2004 budget, the government blocked the budget by refusing claims for any further expenditure.[9] This measure, geared to safeguard the deficit target, was not anticipated by the Commission services in the autumn 2004 forecast, which accordingly projected a somewhat higher deficit outcome of 2.3% of GDP.

Box 1: The revision of government accounts

In the framework of the March 2004 EDP reporting, Eurostat noted an inadequate delimitation of general government and urged the Ministry of Finance to correct it in time for the September 2004 notification. On that occasion, two entities hitherto classified outside the government, the so-called extra-budgetary funds, have been included in the government accounts. The Capital Fund helps to finance the pay-as-you-go system by managing assets to cover for the liabilities of the Pension and Disability Insurance Fund. The Restitution Fund was established for restitution of nationalised and confiscated properties to the original owners and for compensation of damages to war and post-war victims. While the inclusion of the former has not had any budgetary effect, the general government balance deteriorated due to the latter running persistent deficits since its creation in 1993. In 2002 and 2003, the Restitution Fund incurred a deficit of 0.2 % of GDP. The methodological adjustment of the government accounting system has also involved the exclusion of certain institutions, such as pharmacies, homes for the elderly and student residences, from the general government sector. The impact on the budget though was negligible. This comprehensive ex-post revision of budgetary data has increased the general government deficit for the period 2000-2003 by 0.2-0.5% of GDP, the most significant correction being in 2000, when the deficit was raised from 3.0% of GDP to 3.5% of GDP.

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8 Adjustments in fuel excise duties are carried out every fortnight as a standard procedure to avoid inflation to be excessively affected by world market price fluctuations.

9 As stipulated in the Implementation Bill to the 2004 supplementary budget, it was within government's discretion to reduce expenditure proportionally – up to 15 billion tolars (0.25 percent of GDP) – to a revenue shortfall in the course of the year, without having to propose the budget to be amended.

5. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

5.1. Evolution of budgetary targets in successive programmes

The programme aims at fiscal consolidation. In spite of expectations of higher growth, however, the adjustment path projects slightly higher deficit levels than anticipated in the May 2004 convergence programme, which already presented higher deficits than the 2003 pre-accession economic programme. Within the new methodological framework, following the recent ex-post revision of government accounts (see Box 1), the projections foresee a sustained deficit reduction after 2005. The deficit target for 2005 is unchanged from the estimated outturn for 2004 at just above 2% of GDP. Thereafter a gradual decline in the deficit is projected, arriving at 1.1 % by 2007. The targets have been revised upwards by 0.2-0.3% of GDP compared to the May 2004 programme, which reflects the revised institutional coverage of the general government sector, i.e. including the expected deficits of the Restitution Fund.

Compared to the previous programmes, the consolidation strategy underlying the convergence programme update remains largely unchanged. It focuses on restructuring general government expenditure and revenue so as to enhance budgetary flexibility. It is noteworthy that the ratios of general government expenditure and revenues increased substantially compared with the May 2004 convergence programme.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance (% of GDP)	**CP January 2005**	**-2.0**	**-2.1**	**-2.1**	**-1.8**	**-1.1**
	CP May 2004	-1.8	-1.7	-1.8	-1.5	-0.9
	PEP August 2003	*-1.9*	*-1.6*	*-1.6*	*-1.3*	*n.a.*
General government expenditure (% of GDP)	**CP January 2005**	**48.2**	**48.2**	**48.0**	**47.4**	**47.4**
	CP May 2004	45.8	47.0	45.7	45.1	43.6
	PEP August 2003	*43.6*	*43.8*	*44.1*	*43.0*	*n.a.*
General government revenues (% of GDP)	**CP January 2005**	**46.2**	**46.1**	**46.0**	**45.6**	**46.3**
	CP May 2004	44.0	45.1	44.0	43.6	42.7
	PEP August 2003	*41.6*	*42.2*	*42.5*	*41.7*	*n.a.*
Real GDP (% change)	**CP January 2005**	**2.5**	**4.0**	**3.8**	**3.9**	**4.0**
	CP May 2004	2.3	3.6	3.7	3.8	3.9
	PEP August 2003	*3.1*	*3.9*	*4.0*	*4.4*	*n.a.*

Sources:
Convergence programmes (CP); pre-accession economic programme (PEP)

5.2. Budgetary targets in the updated programme

The new government is determined to keep the general government deficits below the 3% of GDP reference value throughout the programme period in view of the EMU entry plans. Achieving a general government budget position of close-to-balance has been confirmed as the key policy objective. To this end, the convergence programme projects a decline in the deficit in nominal and in cyclically-adjusted terms to around 1% of GDP by 2007, thereby moving closer to but not actually achieving a close-to-balance position during the period covered by the programme. Conferring to fiscal policy an important role in contributing to an improved economic performance (bolstering economic growth and competitiveness of the Slovene economy) the programme also emphasises the need to respond suitably to economic shocks. It states that, moving forward with integration into EMU, sound public finances would give fiscal policy more room for manoeuvre in case of asymmetric shocks.

According to the new consolidation path, the deficit halves over the next four years, whereby the adjustment remains relatively back-loaded, as in the May 2004 programme. While no reduction is envisaged for 2005 – the general government deficit thus staying at 2.1% of GDP – 2006 should see the deficit decline to 1.8% of GDP, and further to 1.1% in 2007. By the far end of the programme period, the primary balance is expected to turn positive. The deficit reduction is a result of a number of fiscal policy measures – already ongoing or planned – whereby the adjustment occurs mostly through a cut in the expenditure ratio.[10]

The fiscal consolidation is back-loaded as the main measures envisaged in the programme should take full effect in 2006. On the revenue side, direct tax regimes are being reformed so as to increase the tax capacity (see Box 2). Furthermore, since 2003 policy efforts have duly focused on restructuring public sector expenditure (see Box 2). The new government has announced to review and adjust the reform package designed to cut the high share of fixed spending commitments, currently still accounting for more than 80% of total outlays. Containing public sector wages and social benefits by insisting on de-indexation is considered paramount. However, the considerable reduction of the general government deficit foreseen in 2007 is exclusively due to a significant increase in the revenue ratio based on the assumption that Slovenia would be a net recipient from the EU budget in the amount of 0.8% of GDP, a twofold compared to the revenue assumed for 2005-2006.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	46.2	46.1	46.0	45.6	46.3	**+0.2**
of which:						
- Taxes & social security contributions	40.4	39.6	39.0	38.6	38.6	**-1.0**
- Other (residual)	5.8	6.5	7.0	7.0	7.7	**+1.2**
Expenditure	48.2	48.2	48.0	47.4	47.4	**-0.8**
of which:						
- Primary expenditure	46.1	46.3	46.2	45.7	45.8	**-0.5**
of which:						
Gross fixed capital formation	2.8	2.9	2.9	2.8	3.0	**+0.1**
Collective consumption	8.4	8.3	8.3	8.1	7.9	**-0.4**
Transfers & subsidies	20.8	20.5	20.3	20.1	20.0	**-0.5**
Other (residual)	14.2	14.5	14.8	14.7	15.0	**+0.5**
- Interest payments	2.1	1.9	1.8	1.7	1.6	**-0.3**
Budget balance	**-2.0**	**-2.1**	**-2.1**	**-1.8**	**-1.1**	**+1.0**
Primary balance	**-0.5**	**-0.6**	**-0.6**	**-0.3**	**0.3**	**+0.9**

Sources:
Convergence programme update; Commission services calculations

[10] The expenditure and revenue ratios are not disaggregated in line with ESA95 methodology. The ratios of “other” revenue and expenditure – slightly below 6% to increase to almost 8%, and around 15% of GDP, respectively – are very high compared to a standard ESA reporting. By clearly specifying the items included in “other expenditure” in the update, however, the transparency of accounting is not impaired.

Box 2: The budget for 2005

The new government has expressed the intention to adopt a supplementary budget for 2005 after it will have duly revised the revenue projections as well as reviewed the composition of expenditures in line with the new priorities. It has already announced that the new direct tax regime, effective since 1 January 2005, would be amended shortly so as to further reduce the tax burden on wages. The current deficit target, nevertheless, will be maintained.

In the 2005 budget, which was adopted in December 2003, the key features concern the revenue measures improving tax administration as well as reforming the direct tax regime. In 2004, new personal and corporate income tax legislation was adopted, effective as of 1 January 2005. The new personal income tax regime, designed to provide tax relief to the lowest income classes, has been estimated to reduce government revenues by 0.2% of GDP in 2005. This was expected to be compensated by an increase in corporate income tax, following a broadening of the tax base and the elimination of loopholes in the legislation. Also, further harmonisation of excise duties with the *acquis* should remain a stable revenue source. On the other hand, as border controls are replaced by the European declaration system – regarded as less efficient by the authorities – losses in VAT receipts and customs duties, amounting to 0.3% of GDP, have been anticipated. On the expenditure side, the measures enhancing cost effectiveness and flexibility (in particular, moderation of wages and social transfers through weakened indexation mechanisms) have been expected to result in savings of about 0.6% of GDP, which would be partly offset by additional spending commitments related to EU membership (e.g. Schengen border, top-up payments related to the farming sector).

While the programme highlights the constraints due to entitlements and other legal obligations, keeping the share of mandatory expenditure high, the authorities consider that the restructuring of the budget is necessary in view of the financial implications of NATO and EU membership (although the net budgetary impact of the latter is explicitly recognised to be positive).

As the fiscal projections are based on a broadly plausible macroeconomic scenario, no significant risks to the budgetary targets stem thereof. More generally, the risks to the targets seem balanced. On the one hand, it is at the government’s discretion to refuse claims for further expenditure to safeguard the deficit target in case it is threatened by unfavourable conditions, as was done in 2004. In addition, the yearly loss of VAT revenue at 0.3% of GDP may be overestimated, implying that tax revenue projections err on the side of caution. On the other hand, the budgetary strategy faces implementation risks as the direct tax regime reform, effective as of 1 January 2005, has been judged inadequate by the new government and will be amended shortly while some provisions are being challenged in the constitutional court. Furthermore, the outcome for 2007 is partly due to the new EU financial perspective 2007-2013, anticipating a significant rise in the net budgetary inflows from the EU budget, to amount to 0.8% of GDP, up from 0.4% the year before. Moreover, there is a risk of expenditure overruns, particularly on pension outlays, should the review of the current pension indexation formula, announced for 2006, lead to a loosening of the parameters.

Table 5: Budgetary targets and output gaps

	2003		2004		2005		2006		2007	Change: 2007-2004
	COM	CP	COM	CP	COM	CP	COM	CP	CP	CP
Budget balance[2]	-2.0	-2.0	-2.3	-2.1	-2.2	-2.1	-1.9	-1.8	-1.1	+0.9
Output gap[1,3]	-1.4	-1.3	-0.9	-1.2	-0.6	-1.2	-0.1	-1.3	-1.3	-0.1

Notes:
[1]CP (convergence programme): Commission services calculations on the basis of the information in the programme
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

Having regard to the risks outlined above, the budgetary stance may not provide a sufficient safety margin to avoid a breach of the 3% of GDP deficit threshold with normal cyclical fluctuations throughout the programme period. Furthermore, it is not sufficient to achieve the Stability and Growth Pact's medium-term objective of a budgetary position of close-to-balance by 2007.

The budgetary consolidation strategy sets rather unambitious deficit targets. The pace of the deficit reduction has been left unchanged from the May 2004 convergence programme, while the outlook for the economy has improved somewhat. A failure to pursue budgetary consolidation when growth conditions are favourable may lead to a deterioration in underlying budget positions and inadequate room for the automatic stabilisers to operate in a subsequent economic slowdown.

5.3. Sensitivity analysis

The convergence programme contains a sensitivity analysis that explores the potential effect of shocks to three key economic variables on budgetary projections for 2005. i) An oil price shock (featuring as a sustained rise of prices by 10$ per barrel), ii) rapidly declining nominal interest rates (translated to further strengthening of domestic consumption) and iii) a substantial loss in Slovenia's competitiveness position (resulting in an increase of the average number of unemployed by 4200) were simulated. The analysis of the responsiveness of the government deficit revealed only a minor impact – up to 0.2% of GDP.

6. EVOLUTION OF THE DEBT RATIO

The re-classification of the two extra-budgetary funds, the Capital Fund and the Restitution Fund (see Box 1), into the general government sector led to the upward revision of the debt ratios by 0.7-2.4% of GDP in the period 2000-2003. Compared to the May 2004 convergence programme, when gross government debt was estimated to reach 29.1% of GDP in 2004, the updated programme reveals debt at 30.2% of GDP, up from 29.4% the year before.

Over the programme horizon, the debt ratio is set to remain relatively low although the government anticipates a further rise in the next two years given the persistent primary deficit. Gross government debt is expected to peak at 30.9% of GDP in 2006, when the debt incurred by the health fund[11] and by the non-profit public health institutions is transferred to the state budget. The contribution of the primary balance is broadly offset by the snow-ball effect throughout the period, implying that the stock-flow adjustments largely gear the rise in the debt ratio until 2006 and the fall thereafter. The relation between nominal GDP growth and the interest rate should facilitate the stabilisation of debt, which is forecast to decline to 29.7% of GDP by 2007. The Commission services autumn 2004 forecast, on the other hand, predicted the debt ratio to increase to 30.9% of GDP in 2004 and to broadly stabilise around that level thereafter (under a no-policy change assumption). The Commission services' projections did not account for the revenue generated by the sale of state property, in the absence of clear plans on how to use privatisation proceeds to retire the public debt. The programme remains silent on the intentions what state-owned equity is to be sold when, therefore, the effect of the privatisation proceeds on the level of debt servicing cannot be inferred.

Concerning the risk of negative shocks to the debt, the legislative framework on state guarantees, which limits the issuance of new commitments, seems to effectively reduce the risk associated with contingent liabilities. Neither do the authorities see any risk stemming from the debt portfolio. Inflation and exchange rate developments are not expected to significantly affect the debt level over the medium term since a long-term repayment profile spreads evenly over time while the currency structure supports a growing share of tolar-denominated debt and a predominantly euro-denominated external debt. Furthermore, the government plans to enforce a more active policy of debt management and expects to lower the contribution of interest expenditure to the change in gross debt from 1.9 percentage points of GDP in 2004 to 1.6 percentage points of GDP by 2007.[12]

[11] The health fund is a compulsory social insurance funds, classified within the general government.

[12] In 2003, the first 10-year government bond with a fixed nominal interest rate was issued. This was used in the assessment of long-term interest rate convergence in the Convergence Report 2004 (SEC(2004)1268 of 20.10.2004).

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio	28.6	30.9	30.2	30.8	30.7	30.6	30.9	29.7
Change in debt ratio (1 = 2+3+4)	1.0	1.4	0.7	0.0	0.5	-0.2	0.2	-1.2
Contributions:								
- **Primary balance** (2)	0.3	0.3	0.2	0.2	0.3	0.1	0.1	-0.5
- **“Snow-ball” effect** (3)	-0.2	-0.3	-0.3	-0.1	-0.2	-0.2	-0.2	-0.4
- Interest expenditure	2.3	2.0	1.9	1.9	1.8	1.8	1.7	1.6
- Real GDP growth	-0.8	-1.1	-1.1	-1.0	-1.1	-1.1	-1.1	-1.2
- Inflation (GDP deflator)	-1.8	-1.2	-1.1	-1.0	-0.9	-0.9	-0.8	-0.8
- **Stock-flow adjustment** (4)	0.9	1.4	0.9	-0.1	0.4	-0.1	0.3	-0.3
- Cash/accruals	0.0							
- Accumulation of financial	0.1							
assets	-1.2							
of which: Privatisation proceeds	0.7							
- Valuation effects & residual adj.								

Note:

The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

Sources:

Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The programme reviews the government’s structural reform agenda which focuses on enhancing the competitiveness of the economy by encouraging entrepreneurship and increasing the share of R&D expenditures in the budget. Moreover, the programme sees further restructuring of the banking system as necessary to facilitate the operation of new businesses. It also announces measures to sustain economic growth, e.g. improving education and training as well as promoting job-creation oriented investment and removing structural rigidities in the labour market.

The broad economic policy guidelines related to the challenge on increasing the employment rate (of older workers) invited Slovenia to review the tax/benefit system. In 2004, the authorities adapted the tax system with the aim to reduce labour costs. In September, the amended act on the payroll tax entered into force, raising the minimum threshold for payment of tax. Furthermore, certain measures addressing structural shortcomings, such as the low employment levels of older workers and the large share of long-term unemployment have been adopted. The measures are channelled through the tax system in a way to give employers the incentive to hire older workers and the long-term unemployed. Additional measures in the payroll tax are planned to alleviate the tax burden on labour.

Moreover, some measures were taken with the aim to boost economic growth through the promotion of innovation and technological development. Investments in research and employment creation, in particular, are entitled to tax relief, which should encourage entrepreneurship, one of the key challenges identified by the broad economic policy guidelines. Consistent with the relevant country-specific broad economic policy guidelines are also the measures planned for improving conditions for sustained productivity growth by increasing the share of R&D-related expenditure in the budget. Currently accounting for 1.5% of GDP, the highest among the ten new member states, the share of public funding is to move closer to the EU average whereby policy action will particularly target the applied research projects and the transfer of know-how to the private sector.

In the update of the convergence programme, the authorities have made a commendable effort to quantify the impact of the planned reforms on the projections of the main fiscal aggregates. The overall effect of reducing and restructuring the general government expenditure has been estimated to result in savings, increasing from 0.4% of GDP to 1.3% of GDP by 2007.

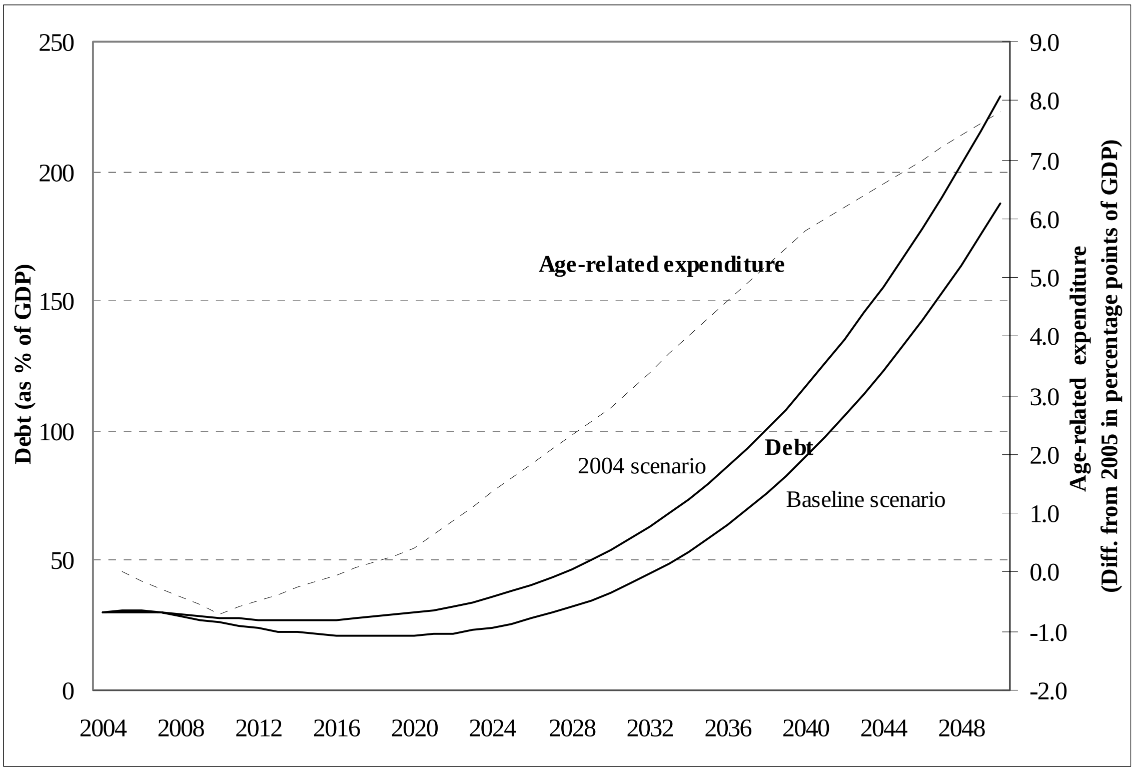
8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of the Slovene public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt developments according to two different scenarios, to take into account different budgetary developments over the medium term. The “programme” scenario (baseline) assumes that the medium-term objective set in the programme is actually achieved, while the “2004” scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents gross debt developments according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by 8.2% of GDP between 2008 and 2050 (see Annex 2 for a breakdown of different age-related expenditures), in particular after 2020 when the full impact of ageing kicks in. Gross debt is projected to remain broadly constant over the next 15 years, but to have an explosive path thereafter[13].

[13] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	2.1	4.7	5.5
2004 scenario	2.9	5.4	5.5

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -95.1%
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the 60% of GDP Treaty reference value in the very long run (year 2050).[14] S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, Slovenia should increase its tax ratio permanently by at least 4.7 percentage points compared with the projected one at the end of the programme period. This would lead to a negative debt ratio by the middle of this century[15]. The budgetary effort over the first 5 years of the

[14] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and potential imbalances after the end of the projection period.

[15] The debt ratio of around -95% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the

projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of about 5.5% of GDP, compared with a primary surplus of 0.5% of GDP targeted for the last year of the programme period.

In interpreting these results, several factors must be taken into account.

First, the parametric pension reform, adopted in 1999 and gradually phased in since 2000, has already produced positive fiscal effects: the average retirement age has increased and pension expenditure as a percentage of GDP has declined. Some progress has been made in the public sector after an agreement to replace the increase of the basic wage, set for August 2003, with a pension insurance premium into the second pillar of the pension system. Following this decision, 20% of the active labour force is covered by the collective supplementary pension insurance. Implementing thoroughly the reform of the pay-as-you-go system as scheduled should alleviate the age-related budgetary pressures provided that the announced changes to the existing method of pension adjustments – only vaguely specified in the programme – do not go in the direction of relaxing the indexation formula.

Second, the update of the programme duly notes the budgetary risks related to health-care expenditure in view of an ageing population. In 2004, the rationalisation of the health-care system was underway, limited mostly to measures containing expenditure (replacing original by generic medicines) and improving efficiency (reducing waiting lines). However, a full-fledged reform of the health-care system, which will restructure the financing of public health services in a fiscally sustainable way, yet needs to be designed. Although the Pension and Disability Insurance Fund and the Health Insurance Fund are not expected to run deficits after 2005, developments regarding the financing of the two compulsory social insurance funds should nevertheless be closely monitored.

* * *

S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

Annex 1: Summary tables from the convergence programme update

Table 1. Growth and associated factors

	2003	2004	2005 (1)	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	2.5	4.0	3.8	3.9	4.0
GDP *level* at *current* market prices, SIT bn.	5747.2	6194.5	6626.0	7066.4	7546.5
GDP deflator	5.5	3.6	3.1	2.6	2.7
HICP change (2)	5.6	3.6	3.0	2.7	2.6
Employment growth (3)	-0.3	0.4	0.3	0.4	0.5
Labour productivity growth (4)	2.8	3.6	3.5	3.5	3.5
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	2.7	3.5	3.4	3.1	3.4
2. Government consumption expenditure	2.6	2.7	2.9	2.9	2.8
3. Gross fixed capital formation	6.3	7.4	7.0	5.5	6.0
4. Changes in inventories and net acquisition of valuables as a % of GDP	1.4	1.5	1.5	1.6	1.5
5. Exports of goods and services	3.2	8.5	5.8	6.6	6.6
6. Imports of goods and services	6.8	9.2	6.5	6.5	6.3
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	3.6	4.4	4.4	3.8	4.1
8. Change in inventories and net acquisition of valuables (=4)	1.1	0.3	0.1	0.2	0.0
9. External balance of goods and services (5-6)	-2.2	-0.7	-0.7	-0.1	-0.1

(1) Forecasts.
(2) CPI change - forecasts of the Institute for Macroeconomic Analysis and Development (IMAD).
(3) Employed population, domestic concept, according to national accounts definition.
(4) Growth of GDP at market prices per person employed at constant prices.

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors					
1. General government	-2.0	-2.1	-2.1	-1.8	-1.1
2. Central government	-1.9	-2.0	-2.1	-1.8	-1.2
3. State government					
4. Local government	0.0	0.0	0.0	0.0	0.0
5. Social security funds	-0.1	-0.1	0.1	0.0	0.1
General government					
6. Total receipts	46.2	46.1	46.0	45.6	46.3
7. Total expenditures	48.2	48.2	48.0	47.4	47.4
8. Budget balance	-2.0	-2.1	-2.1	-1.8	-1.1
9. Net interest payments	1.5	1.5	1.5	1.5	1.4
10. Primary balance	-0.5	-0.6	-0.6	-0.3	0.3
Components of revenues					
11. Taxes	25.2	25.0	24.5	24.4	24.4
12. Social contributions	15.2	14.6	14.5	14.2	14.2
13. Interest income	0.6	0.4	0.3	0.2	0.2
14. Other	5.8	6.1	7.0	6.9	7.7
15. Total receipts	46.2	46.1	46.0	45.6	46.3
Components of expenditures					
16. Collective consumption	8.4	8.3	8.3	8.1	7.9
17. Social transfers in kind	2.1	2.1	2.1	2.0	2.0
18. Social transfers other than in kind	17.2	17.0	16.7	16.4	16.1
19. Interest payments	2.1	1.9	1.8	1.7	1.6
20. Subsidies	1.5	1.4	1.5	1.7	1.9
21. Gross fixed capital formation	2.8	2.9	2.9	2.8	3.0
22. Other	14.2	14.5	14.8	14.7	15.0
23. Total expenditures	48.2	48.2	48.0	47.4	47.4

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	29.4	30.2	30.7	30.9	29.7
Change in gross debt	-0.1	0.8	0.5	0.2	-1.2
Contributions to change in gross debt					
Primary balance	0.5	0.6	0.6	0.3	-0.3
Interest payments	1.5	1.5	1.5	1.5	1.4
Nominal GDP growth	-2.2	-2.1	-2.0	-1.9	-2.0
Other factors influencing the debt ratio	0.1	0.8	0.4	0.3	-0.3
Of which: Privatisation receipts					
p.m. implicit interest rate on debt	6.7	6.0	5.3	5.1	4.8

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	2.5	4.0	3.8	3.9	4.0
2. Actual balance	-2.0	-2.1	-2.1	-1.8	-1.1
3. Interest payments	2.1	1.9	1.8	1.7	1.6
4. Potential GDP growth	3.7	3.6	3.8	3.7	3.7
5. Output gap	-1.2	-0.8	-0.8	-0.6	-0.2
6. Cyclical budgetary component	-0.7	-0.4	-0.4	-0.3	-0.1
7. Cyclically-adjusted balance (2-6)	-1.3	-1.7	-1.6	-1.5	-1.0
8. Cyclically-adjusted primary balance (7-3)	0.2	-0.1	-0.1	0.0	0.4

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	2.3	3.6	3.7	3.8	3.9
Latest update	2.5	4.0	3.8	3.9	4.0
Difference	0.2	0.4	0.1	0.1	0.1
Actual budget balance					
Previous update	-1.8	-1.9	-1.8	-1.5	-0.9
Latest update	-2.0	-2.1	-2.1	-1.8	-1.1
Difference	-0.2	-0.2	-0.3	-0.3	-0.2
Gross debt levels					
Previous update	28.6	29.1	29.5	29.4	28.4
Latest update	29.4	30.2	30.7	30.9	29.7
Difference	0.8	1.1	1.2	1.5	1.3

Table 6. Long-term sustainability of public finances

% of GDP	**2005**	**2010**	**2020**	**2030**	**2040**	**2050**
Total expenditure	48.3	47.5	46.7	48.0	51.2	55.7
Old age pensions	13.3	12.4	13.2	14.9	16.9	18.2
Health care (including care for the elderly)	6.7	6.9	7.2	7.9	8.9	9.6
Interest payments	1.6	1.2	0.4	0.0	0.8	3.6
Total revenues	46.2	46.6	46.6	46.2	45.9	45.0
Of which: from pension contributions	9.6	9.7	9.8	9.9	10.0	10.2
National pension fund assets (if any)						
Assumptions						
Labour productivity growth	3.4	3.4	2.9	2.4	2.1	1.9
Real GDP growth	3.7	3.9	2.6	1.7	1.0	0.9
Participation rate males (aged 20-64)	71.3	73.8	76.8	78.8	80.9	84.6
Participation rates females (aged 20-64)	63.4	66.0	69.0	73.0	75.0	75.0
Total participation rates (aged 20-64)	67.4	70.0	73.0	76.0	78.0	80.0
Unemployment rate	6.3	3.6	2.0	2.0	2.0	2.0

Table 7. Basic assumptions

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)					
Long-term interest rate (annual average)					
United States: short-term (three-month money market)					
United States: long term (10-year government bonds)					
USD/€ exchange rate (annual average)					
Nominal effective exchange rate (euro area)					
Nominal effective exchange rate (EU)					
SIT/€ exchange rate (annual average)					
World GDP growth, excluding EU					
United States, GDP growth					
Japan, GDP growth					
EU-15 GDP growth					
Growth of relevant foreign markets					
World import volumes, excluding EU					
World import prices (goods, in USD)					
Oil prices (Brent, USD/barrel)					
Non-oil commodity prices (in USD)					

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	19.6	19.3	20.4	22.8	25.8	27.8	8.2
Pensions	12.8	12.4	13.2	14.9	16.9	18.2	5.4
Health care	6.8	6.9	7.2	7.9	8.9	9.6	2.8
*Total primary non age-related spending**	26.1						
*Total revenues**	46.3						

*constant

Results (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	28.5	25.9	21.0	37.7	89.9	187.4	158.8
i + 0.5*	28.5	26.2	22.3	40.4	96.4	203.0	174.4
2004 scenario							
Gross debt	29.3	28.0	29.8	54.2	117.0	229.3	200.1
i + 0.5*	29.3	28.3	31.3	57.9	125.7	249.7	220.4

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.