



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.2.2005  
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Recommendation for a

**COUNCIL OPINION**

**in accordance with the third paragraph of Art. 9 of  
Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the updated convergence programme of Slovenia, 2004-2007**

(presented by the Commission)

## EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies<sup>1</sup> stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission. In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 do not participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

The first convergence programme of Slovenia, covering the period 2004-2007, was submitted on 14 May 2004 and assessed by the Council on 5 July 2004. Slovenia submitted an update of its convergence programme on 10 January 2005. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct<sup>2</sup>, the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies<sup>3</sup>. This evaluation warrants the following assessment:

- 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”. 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

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<sup>1</sup> OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website: [http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

<sup>2</sup> Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

<sup>3</sup> COM(2002) 668, 27.11.2002.

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  $\pm 15\%$  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) – 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  $\frac{1}{4}\%$  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, some assumptions underlying the fiscal projections raise concern about public finances in the medium term. In particular, the outcome for 2007 is partly due to the new EU financial perspectives 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.

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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.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated convergence programme of Slovenia and is forwarding it to the Council.

Recommendation for a

## COUNCIL OPINION

**in accordance with the third paragraph of Art. 9 of  
Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the updated convergence programme of Slovenia, 2004-2007**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies<sup>4</sup>, and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [8 March 2005] the Council examined the updated convergence programme of Slovenia, which covers the period 2004 to 2007. The programme partly complies with the data requirements of the “code of conduct on the content and format of stability and convergence programmes”. In particular, government accounts still fail to fully abide by ESA95 standards, evidenced in the high share of “other” revenue and expenditure as percentage of GDP. Therefore, Slovenia is invited to achieve compliance with the data requirements.
- (2) On the basis of currently available information, the macro-economic scenario underlying the programme seems to reflect plausible growth assumptions. It envisages real GDP growth, estimated at 4.0% in 2004, to continue growing at around that level throughout the rest of the programme period. The projections for inflation, on the other hand, appear on the low side of the current forecasting range.
- (3) The budgetary strategy underlying the programme aims at achieving sound public finances as defined by a budgetary position of close-to-balance, but not during the programme period. The programme envisages a gradual reduction of the general government deficit over the period covered, consistent with a sustained cut in the expenditure share as percentage of GDP. The revenue ratio, after falling steadily until

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<sup>4</sup> OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: [http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

2006, rebounds towards the end of the programme period in view of the net positive budgetary impact of EU membership. According to the adjustment path, the deficit halves over the next four years, reaching just above 1% in 2007. Compared with the previous programme, the current update broadly confirms the planned adjustment against a slightly more favourable macroeconomic scenario.

- (4) 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 the government's discretion to refuse claims for further expenditure to safeguard the deficit target should it be threatened by unfavourable conditions, in the manner exercised in 2004. In addition, the yearly loss of VAT revenue at 0.3% of GDP budgeted for 2005-2007 may be overestimated, rendering the tax revenue projections overly cautious. On the other hand, the outcome for 2007 is partly due to the new EU financial perspectives 2007-2013, anticipating a significant rise in the net budgetary inflows from the EU budget. 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.
- (5) In view of this risk assessment, the budgetary stance in the programme may not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations over the programme period. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close-to-balance is achieved by 2007.
- (6) Gross government debt is relatively low: the debt ratio is estimated to have reached 30.2% of GDP in 2004, well below the 60% of GDP Treaty reference value, and to attain 29.7% by 2007.
- (7) 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 the public finances.

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In view of the above assessment, the Council is of the opinion that Slovenia should:

- (i) seize all opportunities to accelerate the reduction of the general government deficit;
- (ii) undertake further reform of the pension and health-care system to improve the long-term sustainability of the public finances.

### Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	<b>CP January 2005</b>	<b>4.0</b>	<b>3.8</b>	<b>3.9</b>	<b>4.0</b>
	COM October 2004	4.0	3.6	3.8	n.a.
	<i>CP May 2004</i>	3.6	3.7	3.8	3.9
HICP inflation (%)	<b>CP January 2005<sup>1</sup></b>	<b>3.6</b>	<b>3.0</b>	<b>2.7</b>	<b>2.6</b>
	COM October 2004	3.9	3.4	3.0	n.a.
	<i>CP May 2004<sup>1</sup></i>	3.3	3.0	2.7	2.6
General government balance (% of GDP)	<b>CP January 2005</b>	<b>-2.1</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.1</b>
	COM October 2004	-2.3	-2.2	-1.9	n.a.
	<i>CP May 2004</i>	-1.9	-1.8	-1.5	-0.9
Primary balance (% of GDP)	<b>CP January 2005</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.2</b>	<b>0.4</b>
	COM October 2004	-0.3	-0.2	-0.1	n.a.
	<i>CP May 2004</i>	-0.3	-0.4	-0.2	0.4
Government gross debt (% of GDP)	<b>CP January 2005</b>	<b>30.2</b>	<b>30.7</b>	<b>30.9</b>	<b>29.7</b>
	COM October 2004	30.9	30.8	30.6	n.a.
	<i>CP May 2004</i>	29.1	29.5	29.4	28.4
<p><u>Note:</u>  <sup>1</sup> CPI inflation for the convergence programme.</p> <p><u>Sources:</u>  <i>Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM).</i></p>					