COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2005-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Slovenia was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of Slovenia and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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

[2] Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Assessment

(1) The second update of the Slovene convergence programme, covering the period 2005-2008, was submitted on 8 December 2005. The updated programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[3].

(2) In its opinion of 8 March 2005 on the previous update of the convergence programme, covering the period 2004-2007, the Council invited Slovenia to (i) seize all opportunities to accelerate the reduction of the general government deficit and (ii) undertake further measures to improve the long-term sustainability of the public finances, including the reforms of the pension and health-care systems.

(3) Following a transition recession in the early nineties, the Slovene economy fully restored robust GDP growth averaging nearly 4% over the last decade. Inflationary pressures have been successfully curbed and consumer price growth approached the EU average by the end of 2005. The general government balance slipped in 1997 and stayed negative since then, with deficits averaging 3% of GDP on an ESA95 basis in the period 2000-2004.

(4) The macroeconomic scenario, where GDP growth is projected to remain at around 4% throughout the programme period against buoyant domestic demand, appears plausible. Cyclical conditions are likely to improve gradually; the negative output gap, estimated to have stood at 1% of GDP in 2005, is forecast to close by the end of the period. The growth assumptions do not include the impact of a reform plan approved in October 2005, which is expected to accelerate growth to over 5% on average after 2008. This seems somewhat optimistic, especially as the programme fails to provide details on how the structural reforms would affect (potential) growth.

(5) In 2005, inflation became volatile but continued to decline on average, dropping to 2.5% by the end of the year (3.7% in 2004). The government remained committed to prudence in regulating administered price increases and indirect tax changes. Moreover, regular adjustments of excise duties to counteract the adverse effects of high oil prices helped in reining inflation. Furthermore, disinflation has been fostered by ERM II membership. The tolar has stayed very close to the central parity of 239.64 SIT/EUR ever since Slovenia joined ERM II on 28 June 2004. The long-term interest rate spread has been fluctuating within, and occasionally even much below, 100 basis points since April 2004, closely mirroring the development of bond yields in the euro area. The monetary authorities recognise constraints in adjusting the policy interest rates to keep inflation under control in the run-up to EMU entry. Over the programme horizon, inflation is expected to settle at around 2.5%, which seems realistic but further removal of the remaining structural rigidities needs to be pursued. With a view to introducing the euro in the beginning of 2007, the programme sees as crucial wage moderation and sound public finances.

[3] The programme has gaps in the compulsory and optional data prescribed by the new code of conduct. In particular, compulsory data on labour productivity growth are not available. Also missing are certain optional data concerning labour market developments, sectoral balances and general government debt developments. The table on general government expenditure by function is not included.

(6) As regards budgetary implementation in 2005, the general government deficit for 2005 is estimated at 1.7% of GDP in the Commission services' autumn 2005 forecast, against a target of 2.1% of GDP set in the previous update of the convergence programme. The preliminary outcome is better than expected as revenues had been underestimated based on the new direct tax regime, in force since January 2005.

(7) The updated programme aims at creating conditions for a successful EMU integration while catching-up with average EU income levels. The budgetary strategy is geared to keeping the general government deficit well below 3% of GDP and targets to achieve the medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact by 2008. To that end, the programme announces tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8%, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5% of GDP. The programme envisages a back-loaded consolidation path. In the beginning of the programme period, the general government deficit is expected is to linger at 1.7% of GDP and then slowly decrease, to 1.4% in 2007 and further to 1.0% of GDP in 2008. Compared with the previous programme, the new update postpones the target of achieving a deficit of 1% of GDP by one year against a broadly unchanged macroeconomic scenario.

(8) Based on Commission services' calculations according to the commonly agreed methodology and consistent with the information in the programme, the structural balance, i.e. in cyclically-adjusted terms and net of one-off and other temporary measures, is envisaged to improve by 0.2 percentage point of GDP over the programme horizon. The structural deficit stood at 1¼% of GDP in 2005. Following a slight deterioration, to reach 1½% of GDP in 2006, the deficit is expected to improve gradually thereafter. The new programme sets the medium-term objective (MTO) for the budgetary position in the meaning of the Stability and Growth Pact at a structural deficit of 1.0% of GDP, to be reached by 2008. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of almost 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct, adequately reflecting the debt ratio and average potential output growth in the long term.

(9) The risks attached to the budgetary targets are broadly balanced. Slovenia has established a track record of better-than-projected budgetary outcomes in the recent years, also supported by an effective budgetary mechanism of containing general government expenditures in response to an unexpected revenue shortfall. Furthermore, the assumptions on growth may turn out better than projected, should the structural reforms be implemented timely. However, the absence of clear schedules for cutting government spending to offset the revenue loss due to the tax reform and, especially, in light of the recent decision to re-introduce indexation of pensions to wages, may make the realisation of the targets difficult. In particular, the high share of mandatory expenditure (more than 80% of the overall outlays) is rooted in the rigid regulatory framework, which still awaits political consensus to be restructured in a more flexible way.

(10) In view of this risk assessment, the budgetary stance, as outlined in the updated programme, seems to provide a sufficient safety margin against breaching the 3% of GDP threshold for the deficit with normal macroeconomic fluctuations throughout the programme period. The strategy also seems sufficient to ensure that the programme's MTO will be reached in 2008, as planned. However, the pace of adjustment towards the programme's MTO is not fully in line with the Pact, which sets a "benchmark" in the annual improvement in the structural balance at 0.5% of GDP for euro-area and ERM-II Member States and specifies that the adjustment should be higher in good economic times. While cyclical conditions improve steadily over the programme horizon the structural balance is planned to improve by only 0.25% of GDP.

(11) The programme invokes a temporary deviation on the basis of "major structural reforms", as meant in the revised Stability and Growth Pact and the new code of conduct. The departure from the Pact's benchmark for the speed of structural adjustment is requested by the additional fiscal effort to cope with the revenue shortfall due to the tax reform and against the negative output gap, expected to close only by the end of the programme period. However, the structural reforms on which the temporary deviation is based are insufficiently detailed. Furthermore, the programme does not provide a cost-benefit analysis nor evidence of a significant beneficial impact on the long-term sustainability of public finances. Therefore, the temporary deviation from the adjustment path towards the programme's MTO is not in line with the revised Stability and Growth Pact.

(12) Gross government debt is relatively low and will remain so over the programme period. In 2005, the debt is estimated to have fallen to 29.3% of GDP. The programme foresees a slight increase in the debt ratio in the next two years, peaking at 29.8% of GDP in 2007. By 2008, the debt is forecast to fall to 29.4%, as a favourable stock-flow adjustment is anticipated.

(13) With regard to the sustainability of public finances, Slovenia appears to be at high risk on grounds of the projected budgetary costs of ageing populations. The relatively low debt ratio will contribute to limit the budgetary impact of ageing. However, Slovenia will still face a very large increase in government expenditure. Even though the 1999 pension reform has significantly alleviated future increase in expenditure, its effects have been partly offset by a new indexation rule, i.e. moving from partial to full indexation to wages. Further changes in the pension schemes, as recognised by the programme, will prove necessary at some point to contain future increase in government expenditure and reduce the risk to long-term sustainability. If no further measures are taken to relieve the pressures of age-related expenditure, the long-term sustainability of public finances will be undermined. A careful planning and timely adoption of measures are key in this regard.

(14) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. However, long-term sustainability of public finances is not explicitly identified as the policy priority. Measures remain vague and do not allow an assessment of the feasibility of the strategy in the longer term.

(15) The national reform programme of Slovenia, submitted on 28 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies adoption of the

euro in 2007 as the key priority. Geared to create conditions for a successful EMU integration, including by improving the quality of the public finances, the updated convergence programme bears a close link with the NRP's comprehensive list of policy measures. However, as a number of measures remain largely unspecified, the budgetary implications of the actions outlined in the national reform programme have not been included in the budgetary projections of the convergence programme.

The updated programme aims at containing inflation close to the EU average while projecting a gradual fiscal adjustment path. In view of the above assessment, it would be appropriate for Slovenia to:

i) make a more rapid progress towards achieving the programme's MTO, especially by specifying and implementing the measures underlying the planned reduction of the expenditure ratio as well as by frontloading the adjustment effort;

ii) undertake further measures to improve the long-term sustainability of the public finances, particularly in relation to the pension system.

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, 2005-2008

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[4], 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) Following a transition recession in the early nineties, the Slovene economy fully restored robust GDP growth averaging nearly 4% over the last decade. Inflationary pressures have been successfully curbed and consumer price growth approached the EU average by the end of 2005. The general government balance slipped in 1997 and stayed negative since then, with deficits averaging 3% of GDP on an ESA95 basis in the period 2000-2004.

(2) In its opinion of 8 March 2005 on the previous update of the convergence programme, covering the period 2004-2007, the Council invited Slovenia to (i) seize all opportunities to accelerate the reduction of the general government deficit and (ii) undertake further measures to improve the long-term sustainability of the public finances, including the reforms of the pension and health-care systems.

(3) As regards budgetary implementation in 2005, the general government deficit for 2005 is estimated at 1.7% of GDP in the Commission services' autumn 2005 forecast, against a target of 2.1% of GDP set in the previous update of the convergence programme. The preliminary outcome is better than expected as

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[4] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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

revenues had been underestimated based on the new direct tax regime, in force since January 2005.

(4) On [14 February 2006] the Council examined the updated convergence programme of Slovenia, which covers the period 2005 to 2008. The updated programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct5.

(5) The macroeconomic scenario underlying the programme envisages that real GDP will grow steadily at around 4% beyond 2005. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. Cyclical conditions are likely to improve gradually; the negative output gap, estimated to have stood at 1% of GDP in 2005, is forecast to close by the end of the period. The programme's projections for inflation also appear realistic. As regards "major structural reforms" in the meaning of the Stability and Growth Pact, the programme presents comprehensive socio-economic reforms aiming to enhance the competitiveness of the Slovene industry, the implementation of which started in 2005. They are expected to boost GDP growth from 2008 onwards to over 5% per annum on average. The supporting analysis in the programme is not sufficiently detailed and the expected growth impact appears very optimistic.

(6) The updated programme aims at creating conditions for a successful EMU integration while catching-up with average EU income levels. The budgetary strategy is geared to keeping the general government deficit well below 3% of GDP and targets to achieve the medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact by 2008. To that end, the programme announces tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8%, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5% of GDP. The programme envisages a back-loaded consolidation path. In the beginning of the programme period, the general government deficit is expected is to linger at 1.7% of GDP and then slowly decrease, to 1.4% in 2007 and further to 1.0% of GDP in 2008. Compared with the previous programme, the new update postpones the target of achieving a deficit of 1% of GDP by one year against a broadly unchanged macroeconomic scenario.

(7) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve by around ¼% of GDP. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of 1% of GDP and aims at achieving this position by 2008. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of almost 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and

[5] The programme has gaps in the compulsory and optional data prescribed by the new code of conduct. In particular, compulsory data on labour productivity growth are not available. Also missing are certain optional data concerning labour market developments, sectoral balances and general government debt developments. The table on general government expenditure by function is not included.

adequately reflects the debt ratio and average potential output growth in the long term.

(8) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, Slovenia has established a track record of better-than-projected budgetary outcomes in the recent years, also supported by an effective budgetary mechanism of containing general government expenditures in response to an unexpected revenue shortfall. Furthermore, the assumptions on growth may turn out better than projected, should the structural reforms be implemented timely. However, the absence of clear schedules for cutting government spending to offset the revenue loss due to the tax reform and, especially, in light of the recent decision to re-introduce indexation of pensions to wages, may well impede the realisation of targets. In particular, the high share of mandatory expenditure (more than 80% of the overall outlays) is rooted in the rigid regulatory framework, which still awaits political consensus to be restructured in a more flexible way.

(9) In view of this risk assessment, the budgetary stance in the programme seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. Furthermore, it seems sufficient to ensure that the programme's MTO is reached in 2008, as planned. However, the pace of the adjustment towards the programme's MTO implied by the programme is not fully in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times. While cyclical conditions improve steadily over the programme horizon the structural balance is planned to improve by only 0.25% of GDP.

(10) According to the Stability and Growth Pact, "major structural reforms" with a verifiable impact on the long-term sustainability of the public finances should be taken into account when defining the adjustment path to the programme's MTO or for allowing a temporary deviation from the programme's MTO. The medium-term budgetary strategy outlined in the programme embodies a temporary deviation from the adjustment path towards the programme's MTO. In particular, little or no adjustment towards the programme's MTO occurs between 2005 and 2007, when the above mentioned economic reforms would be gradually implemented. However, the structural reforms on which the temporary deviation is based are insufficiently detailed. Furthermore, the programme does not provide a cost-benefit analysis nor evidence of a significant beneficial impact on the long-term sustainability of the public finances. Therefore, the temporary deviation from the adjustment path towards the programme's MTO is not in line with the revised Stability and Growth Pact.

(11) Gross public debt is estimated to have reached 29.0% of GDP in 2005, well below the 60% of GDP Treaty reference value. The programme projects a slight increase in the debt ratio in the next two years, peaking at 29.8% in 2007. By 2008, the debt is forecast to fall to 29.4% of GDP.

(12) With regard to the sustainability of public finances, Slovenia appears to be at high risk on grounds of the projected budgetary costs of ageing populations[6]. The relatively low debt ratio will contribute to limit the budgetary impact of ageing. However, Slovenia will still face a very large increase in government expenditure. Even though the 1999 pension reform has significantly alleviated future increase in expenditure, its effects have been partly offset by a new indexation rule (moving from partial to full indexation to wages). Further changes in the pension schemes, as recognised by the programme, will prove necessary at some point to contain future increase in government expenditure and reduce the risk to long-term sustainability. If no further measures are taken to relieve the pressures of age-related expenditure, the long-term sustainability of public finances will be undermined. A careful planning and timely adoption of measures are key in this regard.

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. However, long-term sustainability of public finances is not explicitly identified as the policy priority. Measures remain vague and do not allow an assessment of the feasibility of the strategy in the longer term.

(14) The national reform programme of Slovenia, submitted on 28 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies adoption of the euro in 2007 as the key priority. Geared to create conditions for a successful EMU integration, including by improving the quality of the public finances, the updated convergence programme bears a close link with the NRP's comprehensive list of policy measures. However, as a number of measures remain largely unspecified, the budgetary implications of the actions outlined in the national reform programme have not been included in the budgetary projections of the convergence programme.

In view of the above assessment, the Council notes that the programme aims at containing inflation close to the EU average while projecting a gradual fiscal adjustment path. The Council is of the opinion that it would be appropriate for Slovenia to:

i) make a more rapid progress towards achieving the programme's MTO, especially by specifying and implementing the measures underlying the planned reduction of the expenditure ratio as well as by frontloading the adjustment effort;

ii) undertake further measures to improve the long-term sustainability of the public finances, particularly in relation to the pension system.

[6] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec 2005**	**4.2**	**3.9**	**4.0**	**4.0**	**3.8**
	COM Nov 2005	4.2	3.8	4.0	4.2	n.a.
	CP Jan 2005	*4.0*	*3.8*	*3.9*	*4.0*	*n.a.*
HICP inflation (%)	**CP Dec 2005**	**3.6**	**2.5**	**2.5**	**2.4**	**2.4**
	COM Nov 2005	3.6	2.6	2.5	2.5	n.a.
	CP Jan 2005	*3.6*	*3.0*	*2.7*	*2.6*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2005**[1]	**-1.4**	**-1.2**	**-0.7**	**-0.3**	**0.0**
	COM Nov 2005[5]	-1.2	-0.9	-0.5	0.2	n.a.
	CP Jan 2005[1]	*-1.2*	*-1.2*	*-1.3*	*-1.3*	*n.a.*
General government balance (% of GDP)	**CP Dec 2005**	**-2.1**	**-1.7**	**-1.7**	**-1.4**	**-1.0**
	COM Nov 2005	-2.1	-1.7	-1.9	-1.6	n.a.
	CP Jan 2005	*-2.1*	*-2.1*	*-1.8*	*-1.1*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2005**	**-0.5**	**-0.2**	**-0.3**	**-0.1**	**0.2**
	COM Nov 2005	-0.2	-0.1	-0.4	-0.2	n.a.
	CP Jan 2005	*-0.3*	*-0.4*	*-0.2*	*0.4*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2005**[1]	**-1.4**	**-1.2**	**-1.4**	**-1.3**	**-1.0**
	COM Nov 2005	-1.5	-1.5	-1.7	-1.7	n.a.
	CP Jan 2005[1]	*n.a*	*n.a*	*n.a*	*n.a*	*n.a.*
Structural balance[2] (% of GDP)	**CP Dec 2005**[3]	**-1.4**	**-1.2**	**-1.4**	**-1.3**	**-1.0**
	COM Nov 2005[4]	-1.5	-1.5	-1.7	-1.7	n.a.
	CP Jan 2005	*n.a*	*n.a*	*n.a*	*n.a*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2005**	**29.5**	**29.0**	**29.6**	**29.8**	**29.4**
	COM Nov 2005	29.8	29.3	29.5	29.2	n.a.
	CP Jan 2005	*30.2*	*30.7*	*30.9*	*29.7*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] There are no one-off and other temporary measures in the programme.
[4] There are no one-off and other temporary measures in the Commission services' forecast.
[5] Based on estimated potential growth of 3.7%, 3.5%, 3.5% and 3.5% respectively in the period 2004-2007.

Source:
Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.