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**ECONOMIC ASSESSMENT**  
**OF THE STABILITY PROGRAMME OF SLOVENIA**

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. Slovenia’s first stability programme was submitted on 7 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 27 February 2007. Comments should be sent to Mateja Peternejl (mateja.peternejl@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm)

## Table of contents

SUMMARY AND CONCLUSIONS.....	4
1. INTRODUCTION.....	8
2. ECONOMIC TRENDS AND POLICY CHALLENGES .....	8
2.1. Economic performance.....	8
2.2. Anatomy of medium-term growth.....	12
2.3. Macro-policies against the backdrop of the economic cycle.....	13
2.4. Public finances.....	14
2.5. Medium and long-term policy challenges for public finances.....	16
3. MACROECONOMIC OUTLOOK.....	27
3.1. External assumptions.....	27
3.2. Economic activity.....	27
3.3. Labour market developments.....	29
3.4. Costs and price developments.....	29
3.5. Sectoral balances.....	29
3.6. Assessment.....	30
3.6.1. Plausibility of the macroeconomic scenario.....	30
3.6.2. Economic good vs. bad times.....	30
4. GENERAL GOVERNMENT BALANCE.....	30
4.1. Budgetary implementation in 2006.....	30
4.2. The programme's medium-term budgetary strategy.....	31
4.2.1. The main goal of the programme's budgetary strategy.....	31
4.2.2. The composition of the budgetary adjustment.....	32
4.2.3. The medium-term objective (MTO) and the structural adjustment.....	33
4.3. Risk assessment.....	35
4.4. Assessment of the fiscal stance and budgetary strategy.....	38
5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY.....	41
5.1. Recent debt developments and medium-term prospects.....	42
5.1.1. Debt projections in the programme.....	42
5.1.2. Assessment.....	43
5.2. Long-term debt projections and the sustainability of public finances.....	44
5.2.1. Sustainability indicators and long-term debt projections.....	44
5.2.2. Additional factors.....	48
5.2.3. Assessment.....	49
6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES.....	49
7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES.....	50
Annex 1: Glossary.....	53
Annex 2: Summary tables from the programme update.....	56
Annex 3: Compliance with the code of conduct.....	62
Annex 4: Key economic indicators of past economic performance.....	64
Annex 5: Assessment of tax projections.....	66

## SUMMARY AND CONCLUSIONS<sup>1</sup>

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Slovenia, has to submit a stability programme and annual updates thereof. Slovenia submitted its first stability programme, covering the period 2006-2009, on 7 December 2006.

Over the last decade, the Slovene economy has been remarkably stable. The absence of any major imbalances testifies to the strength of the economy and soundness to deal with economic shocks. In particular, inflation was brought down, but price developments need to be closely monitored although wage pressures are expected to stay contained based on the recent pay agreements for both the public and the private sector. The labour market developments have generally been positive but a few structural shortcomings remain, as evidenced, in particular, by low employment of older workers. Job creation could have benefited from further measures to improve the business environment, encourage R&D activities and foster active ageing.

Against this background, the Slovene economy faces the following challenges. First, in the area of stabilisation, the relatively favourable macroeconomic conditions in the medium-term, with the economy growing above potential, offer the opportunity to proceed with fiscal adjustment so as to create more leeway for reacting to cyclical downturns in the future. Second, regarding long-term sustainability, Slovenia appears to be at a high risk of public finances on grounds of the projected budgetary costs of population ageing in the next decades, although the general government debt accounted for less than 30% of GDP at the end of 2005. Further measures to the ongoing pension reform will be needed to bear the cost of demographic changes. Finally, in the area of efficiency, to further advance real convergence it will be necessary to enhance the quality of public finances to help reduce the structural rigidities, improve the business climate and bolster competitiveness. While a comprehensive reform of the tax system has been carried out the need to increase government expenditure flexibility remains largely unaddressed; the share of non-discretionary spending commitments remains more than 80% of the general government outlays.

The macroeconomic scenario underlying the stability programme envisages that real GDP will grow steadily at above 4% over the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation also appear realistic. Given that the negative output gap has been narrowing since 2004 and is expected to turn marginally positive from 2007, the broad economic outlook can be considered as an indication of economic good times over the medium-term.

For 2006, the general government deficit is estimated at 1.6% of GDP in the Commission services' autumn 2006 forecast, against a target of 1.7% of GDP set in the December 2005 update of the convergence programme. The planned reduction of the expenditure ratio seems to have been broadly achieved, but the revenue shortfall is estimated to be

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<sup>1</sup>The analysis takes into account (i) the Commission services' autumn 2006 forecast, (ii) the code of conduct ("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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

higher than budgeted despite the cyclical improvement of the economy and the deficit slightly wider compared to 2005.

The programme's budgetary strategy is geared to achieving the medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact by 2009 through a back-loaded consolidation. Reflecting the ongoing tax reform and a number of cost-saving expenditure measures, revenues and expenditure as a percentage of GDP fall significantly throughout the programme period. Until 2008, when the respective ratios decrease in broadly equal measure, the general government deficit is planned to linger at around 1.5% of GDP. In 2009, the deficit declines to 1.0% as expenditure reduction outweighs the revenue loss. The primary balance initially deteriorates from 0.1% of GDP in 2006 to -0.3% of GDP in 2008 before improving to 0.3% of GDP in 2009. Compared with the last update of the convergence programme, the stability programme postpones the target of achieving a nominal deficit of 1% of GDP by one year against a more favourable macroeconomic scenario.

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  $\frac{1}{4}$ % of GDP. As in the December 2005 update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the stability programme is a structural deficit of 1% of GDP to be achieved by 2009, one year later than in the previous programme. The delay is attributed in the programme to a major railway project with an estimated cost of 0.4% of GDP in 2007, 0.5% of GDP in 2008 and 0.2% of GDP in 2009. The MTO is in line with the Pact.

The risks to the budgetary projections in the programme appear broadly balanced for 2007 and 2008 but in 2009 the budgetary outcome could be worse than projected in the programme. On the one hand, the assumptions on growth and tax revenues seem plausible. Furthermore, Slovenia has established a track record of better-than-projected budgetary outcomes in recent years, also supported by an effective budgetary mechanism of containing general government expenditures in response to an unexpected revenue shortfall. On the other hand, notwithstanding the efforts to restructure the general government expenditure, the share of mandatory expenditure remains very high. The measures that underpin the considerable cut in primary expenditure as a percentage of GDP announced for 2009 remain to be specified in detail.

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2009, as envisaged in the programme. However, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. The pace of the adjustment towards the MTO implied by the programme is insufficient and should be strengthened to be in line with the Stability and Growth Pact. In particular, good times are expected to occur throughout the programme period but the structural balance is not planned to improve noticeably before the last year of the programme. In 2009, however, there may be a risk that the outcome is worse than targeted.

The long-term budgetary impact of ageing in Slovenia is among the largest in the EU, influenced notably by a considerable increase in pension expenditure as a share of GDP. While some action is being taken, implementation of further reform measures aimed at containing the substantial increase in age-related expenditures would contribute, as

recognised by the authorities, to reducing risks to the sustainability of public finances. Although the initial budgetary position contributes to stabilising the debt ratio over the medium term, the low structural improvement over the programme period will not be sufficient to contain the expected budgetary impact of ageing. Overall, as mentioned above, Slovenia appears to be at high risk with regard to the sustainability of public finances.

The implementation report of the National Reform Programme of Slovenia, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 16 October 2006. Slovenia's national reform programme gears policies toward five key challenges: a competitive economy and faster growth; a knowledge-based society; an efficient state; a modern social state and higher employment; and sustainable development. The Commission's assessment of the recent update of this programme showed that Slovenia is making good progress in implementing its National Reform Programme. Slovenia has taken appropriate measures in some key areas such as entrepreneurship and better regulation and has launched most of the major reforms of employment policies. However, progress on the implementation of the active ageing strategy and on the removal of barriers to youth employment has so far not been rapid enough. In the microeconomic area, stronger measures would be needed to enhance the innovation and competition framework. Greater effort would also be desirable as regards restructuring public expenditure. Against the background of strengths and weaknesses identified, Slovenia was recommended to take action in the areas of: long-term sustainability of public finances, in particular with regard to strengthening the pension system and increasing employment of older workers, as well as employment services in relation with flexible contractual arrangements and increased conditionality of benefits.

The stability and the national reform programme are to some extent integrated. In particular, the stability programme provides details of the tax reform announced in the national reform programme and complements the actions envisaged in the national reform programme with expenditure measures.

The overall conclusion is that, while the programme recognises that containing inflationary pressures and continued fiscal consolidation are necessary to preserve the resilience of the economy, it envisages insufficient progress towards the MTO in spite of the upbeat growth prospects.

### Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	<b>SP Dec 2006</b>	<b>4.0</b>	<b>4.7</b>	<b>4.3</b>	<b>4.2</b>	<b>4.1</b>
	COM Nov 2006	4.0	4.8	4.2	4.5	n.a.
	<i>CP Dec 2005</i>	3.9	4.0	4.0	3.8	n.a.
HICP inflation (%)	<b>SP Dec 2006</b>	<b>2.5</b>	<b>2.7</b>	<b>2.7</b>	<b>2.5</b>	<b>2.2</b>
	COM Nov 2006	2.5	2.5	2.5	2.6	n.a.
	<i>CP Dec 2005</i>	2.2	1.5	2.2	2.5	n.a.
Output gap (% of potential GDP)	<b>SP Dec 2006<sup>1</sup></b>	<b>-1.3</b>	<b>-0.5</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.3</b>
	COM Nov 2006 <sup>5</sup>	-1.1	-0.3	0.0	0.4	n.a.
	<i>CP Dec 2005<sup>1</sup></i>	-1.2	-0.7	-0.3	0.0	n.a.
General government balance (% of GDP)	<b>SP Dec 2006</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.0</b>
	COM Nov 2006	-1.4	-1.6	-1.6	-1.5	n.a.
	<i>CP Dec 2005</i>	-1.7	-1.7	-1.4	-1.0	n.a.
Primary balance (% of GDP)	<b>SP Dec 2006</b>	<b>0.4</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.3</b>	<b>0.3</b>
	COM Nov 2006	0.3	-0.1	-0.2	-0.3	n.a.
	<i>CP Dec 2005</i>	-0.2	-0.3	-0.1	0.2	n.a.
Cyclically-adjusted balance (% of GDP)	<b>SP Dec 2006<sup>1</sup></b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.1</b>
	COM Nov 2006	-0.9	-1.5	-1.6	-1.7	n.a.
	<i>CP Dec 2005<sup>1</sup></i>	-1.2	-1.4	-1.3	-1.0	n.a.
Structural balance <sup>2</sup> (% of GDP)	<b>SP Dec 2006<sup>3</sup></b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.1</b>
	COM Nov 2006 <sup>4</sup>	-0.9	-1.5	-1.6	-1.7	n.a.
	<i>CP Dec 2005</i>	-0.4	-1.4	-1.4	-1.0	n.a.
Government gross debt (% of GDP)	<b>SP Dec 2006</b>	<b>28.0</b>	<b>28.5</b>	<b>28.2</b>	<b>28.3</b>	<b>27.7</b>
	COM Nov 2006	28.0	28.4	28.0	27.6	n.a.
	<i>CP Dec 2005</i>	29.0	29.6	29.8	29.4	n.a.

Notes:

<sup>1</sup>Commission services calculations on the basis of the information in the programme.

<sup>2</sup>Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

<sup>3</sup>There are no one-off or other temporary measures in the programme.

<sup>4</sup>There are no one-offs or other temporary measures in the Commission services' autumn 2006 forecast.

<sup>5</sup>Based on estimated potential growth of 3.8% in 2005 and 4% for 2006-2008.

Source:

Convergence/stability programme (CP/SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

## 1. INTRODUCTION

On 7 December 2006, upon government approval, Slovenia submitted the first stability programme,<sup>2</sup> due to be delivered within six months after the ECOFIN Council on 11 July 2006 confirmed Slovenia's entry in EMU<sup>3</sup>. Largely based on the December 2005 convergence programme, it updates a fiscal policy framework, to cover the 2006-2009 period, on the grounds of 2007 and 2008 budget bills which were adopted by parliament on 20 November 2006.

Slovenia's programme adheres to the model structure for stability and convergence programmes specified in the code of conduct. The data requirements have been broadly met, with minor gaps in compulsory<sup>4</sup> and optional<sup>5</sup> data. Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

## 2. ECONOMIC TRENDS AND POLICY CHALLENGES

This section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second part presents the results of a growth accounting exercise and tries to identify the main reasons for the average annual growth performance vis-à-vis the reference aggregate (euro area, hereinafter EUR-12). The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. The fifth part then identifies major economic challenges with implications for public finances.

### 2.1. Economic performance

Slovenia has distinguished itself as one of the best performers in terms of economic development among the new Member States. Already with relatively high per capita income at the time of declaring independence, it has succeeded in making further progress in catching up with the EU level since then. In 2005, the country's GDP per inhabitant in purchasing power standard (PPS) reached 80% of the EUR-25 average.

Over the past ten year, the economy has been growing at close to 4% per annum on average – and thus outperforming the average growth of the EU as a whole by almost 2

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<sup>2</sup> On 1 December, the ultimate deadline for submission of the stability/convergence programme updates set out by the code of conduct, a draft stability programme was made available to the Commission services.

<sup>3</sup> Art. 4 of Council Regulation (EC) No 1466/97 stipulates that "a Member State adopting the single currency at a later stage [i.e. later than 1 January 1999] shall submit a stability programme within six months of the Council decision on its participation in the single currency".

<sup>4</sup> The table on sectoral balances is incomplete, with net external balances for 2006-2007 and statistical discrepancy in 2005 missing. Interest rates, though unavailable, are presumably based on the common assumptions for the Commission services' autumn 2006 forecast.

<sup>5</sup> The assessment is not hampered by the unavailability of optional data regarding labour market developments (based on hours worked), sectoral balances and general government debt. In the table on the long-term sustainability of public finances there is no pension sub-classification and nothing on education and interest expenditure. The optional table on general government expenditure by function is not included.



percentage points – while avoiding major macroeconomic imbalances (see Table 1 for an overview of key economic indicators), even in periods marked by unfavourable conditions in the international environment, e.g. following oil price hikes.

Slovenia has kept its external position in check. A traditionally balanced current account turned negative in 1997 and by 1999 reached a record deficit at 3.3% of GDP. Except for a temporary reversal to modest surpluses in 2001 and 2002, the current account deficit has been lingering above 2% of GDP ever since. Although the structure of financing appears unfavourable – with inward FDI stock to GDP scoring one of the lowest in the EU – Slovenia's external position does not seem to have been undermined.

The rate of internationalisation of Slovenia's economy, measured as the average share of exports and imports in GDP, has increased by more than 10 percentage points since 1995 and reached about 65% in 2005, mostly thanks to the expansion of international trade of goods while services trade has accounted for less than 10% of GDP.

The bulk of export and import flows originates in manufacturing, which corresponds to Slovenia's historical trade specialisation pattern as revealed by the Balassa index.<sup>6</sup> Contrary to other EUR-8 transition economies, Slovenia has shown a stable concentration of trade flows in the medium-low-technology sectors over the entire period. The overall share of intra-industry trade in total trade remains relatively modest compared to the most developed EUR-25 economies. That the trade with the EU partners is largely inter-industry is evidenced by a significant revealed comparative advantage in manufacturing goods with a high content of labour and natural resources. The share of low-tech and labour-intensive products in merchandise exports, albeit falling steadily since 2000, stays above the EUR-10 averages. The factor intensity of exports, however, has been improving in recent years, with the share of medium-tech and high-tech products in the total exports of goods at roughly 55% in 2004 placing Slovenia at the EU average.

Given the relatively low technology content of Slovenia's exports, the export sector has been very sensitive to commodity and oil prices hikes as well as wage pressures. The adverse effects have traditionally been counteracted by the continuous – albeit slowing – depreciation of the effective exchange rate, up until entering into ERM II in June 2004. At present, competitiveness of the Slovene economy appears relatively solid, in particular judging by price indicators. Nevertheless, Slovenia has been the slowest transition economy to conquer the more developed markets. The low technology and skill content of exports expose the Slovene industry to a considerable competition from emerging markets as do the relatively high unit labour costs.

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<sup>6</sup> The Balassa index is defined as the ratio of a country's share in global exports of a given sector and the country's share in global exports of the economy as a whole. A ratio above 1 indicates a revealed comparative advantage of a sector:

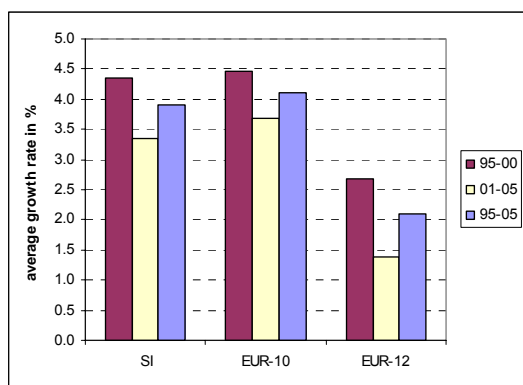
$$B = \frac{X_{cj}}{X_{ct}} \cdot \frac{X_{gt}}{X_{gj}}$$

where X stands for the value of exports in a given period, c indicates the country, g the world as a whole, j the sector and t the economy as a whole (all sectors).

At the same time, labour market developments have been favourable. The employment rate has increased steadily to 65.1 % in 2005, slightly surpassing the EU average, while the unemployment rate at 6.5% was one of the lowest. However, given the low incentives to remain in activity, the employment rate of older workers at 30.7% in 2005 was well below the EU average. Over the past decade, wage growth in Slovenia has generally exceeded wage growth in the EUR-12 as well as in EUR-10 countries. Since 2003, however, wage pressures have been well contained through an economy-wide social agreement, stipulating that wage growth should lag behind productivity growth by at least one percentage point. The agreement has been reflected in wage developments in both the public and the private sector. Between 2003 and 2005, the average gross wage per employee in the private sector has grown by about one percentage point less than productivity in that sector. In the public sector, growth of the average gross wage per employee growth was lower by 1.3 percentage points, on average, than the productivity growth for the whole economy.

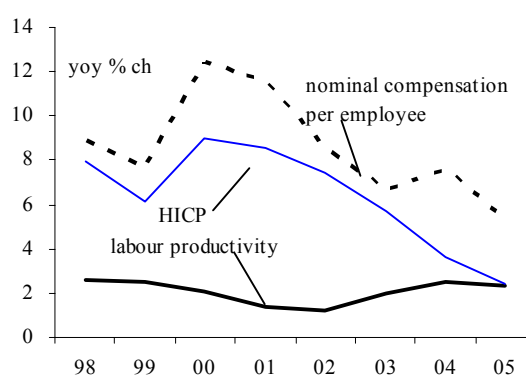
A stringent wage policy has been considered as crucial in curbing inflationary pressures, spurred by the introduction of VAT in 1999. They have been successfully contained after the government and monetary authorities agreed on a co-ordinated policy action in 2003, which involved a mid-term plan of regulated increases of administered prices, caps on tax rises, de-indexation of the economy, wage moderation and a slowing of the rate of depreciation of the exchange rate. By 2006, inflation had approached the EU average. Within the policy setting, aiming at macroeconomic stability, Slovenia has simultaneously reduced the general government deficit from a high at 4.3% in 2001 to 1.4% in 2005.

**Figure 1: Average GDP growth: Slovenia vs. EUR-12 and EUR-10**



*Source:*  
Commission services

**Figure 2: Price and wage developments**



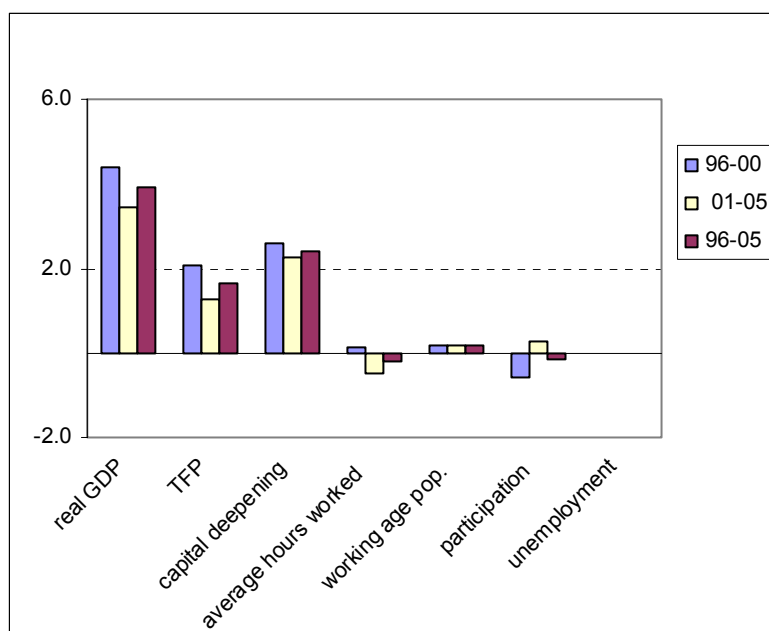
*Source:*  
Commission services

<b>Box 1: Monetary policy and exchange rate regimes of SLOVENIA</b>	
<i>Regime combining money targeting with managed floating (1991 -2001)</i>	In the 1990s, the Bank of Slovenia (BoS) pursued a policy of gradual disinflation, setting targets for the money base stock or for monetary aggregate growth (since 1997). During this period, Slovenia had a managed floating exchange-rate regime with the central bank intervening on the foreign exchange market within the constraints set by the money target.
<i>Two-pillar regime combining money targeting and managed floating / de facto crawling peg (2001 – 2004)</i>	Price stability became the primary objective of monetary policy through an amendment of the Law on the Bank of Slovenia in mid-2002. The Bank pursued price stability by simultaneously modifying the quantity of money in circulation and managing systematically the exchange rate. In order to maintain price competitiveness in an inflationary environment and to prevent interest-rate-sensitive capital inflows in an environment of positive interest-rate differential, the BoS engineered a continuous depreciation of the exchange rate. The management of the exchange rate was enabled by an agreement that the BoS concluded with most of the commercial banks.
<i>ERM II entry - Fixed peg (June 2004)</i>	With ERM II entry, Slovenia switched to a peg vis-à-vis the euro with a fluctuation band of +/- 15%.
<i>Euro zone membership (as of January 2007)</i>	Slovenia joins the euro area in January 2007.

## 2.2. Anatomy of medium-term growth

In terms of growth Slovenia has been consistently outperforming the EUR-12 economies, on average, but has recorded lower growth rates than most of the new Member States. Over the period from 1996-2005, growth in Slovenia has been more capital driven compared with the EUR-12 average. On the other hand, labour appears to have contributed only marginally over the period as a whole owing to a negative contribution of hours worked as well as of participation. The slack in the contribution of labour to Slovenia's growth, in comparison with the EUR-12, is mainly explained in terms of a slower increase of the participation rate in Slovenia, given its relatively favourable starting position. At present, the output of the economy is close to potential, estimated at around 4%, whereby growth continues to be largely generated through capital accumulation. The negative output gap is estimated to have narrowed from 1.6% of potential GDP in 2003 to below 1% in 2005.<sup>7</sup>

**Figure 3: Real GDP growth and its components**



**Note:**

Assuming a Cobb-Douglas-production function  $Y = A(L \cdot H)^\alpha K^{1-\alpha}$  where  $Y$  denotes the level of  $GDP$ ,  $L$  employment,  $H$  the average hours worked per person employed,  $K$  the capital stock and  $\alpha$  the labour share in income, real GDP can be written as  $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$  where  $WP$  stands for working age population,  $PART$  denotes the participation ratio as a share of  $WP$  and  $ur$  the rate of unemployment. In terms of growth rates  $g$  this is:

$$g_Y = g_A + (1 - \alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1 - ur}$$

The expression  $(g_K - g_L - g_H)$  is referred to as capital deepening, i.e. the increase in the capital labour ratio.

**Source:**

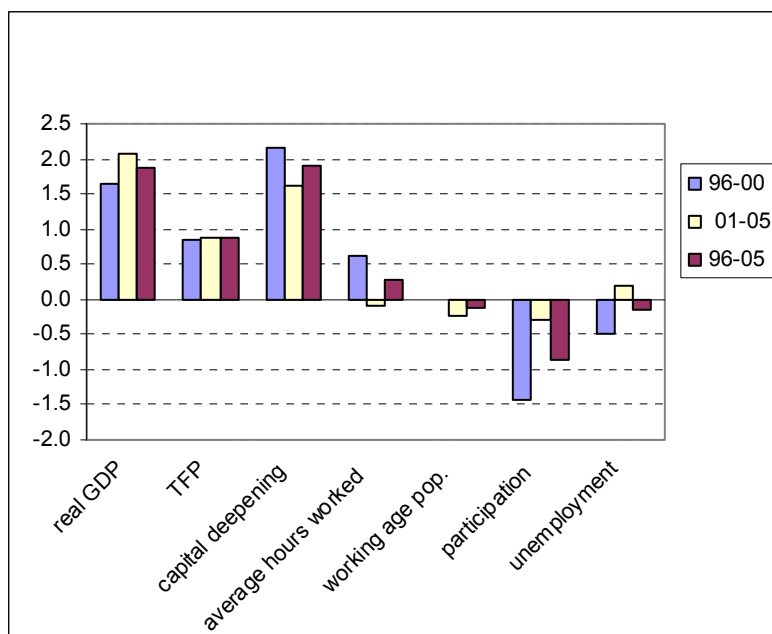
Commission services

Shortcomings remain, resulting in a subdued potential growth. Structural rigidities in the labour and product markets, for instance, impede a faster catching-up with the EU

<sup>7</sup> The calculations of potential growth (and hence the output gap) must be treated cautiously as they are exposed to potentially considerable uncertainty particularly for countries experiencing a catching-up process.

productivity levels. Even though labour productivity has grown faster than in the EU, on average, it only stood at 77% of the EUR-25 average labour productivity (per person employed) in 2005. The concern is that the performance would increasingly suffer from the persisting structural weaknesses due to the delays in privatisation, liberalisation and production capacity restructuring.

**Figure 4: Real GDP growth and its components: Difference vs. EUR-12**



Note:  
See note of Figure 3

Source:  
Commission services

### 2.3. Macro-policies against the backdrop of the economic cycle

Following a period of a short recession – typical for all EUR-8 countries in the early years of transition – GDP growth picked up in 1993 and remained steady at 3-5% since then. After a slack in 2003 due to unfavourable conditions in the international environment, the economy quickly recovered its strength. Average real GDP growth between 2000 and 2005 fell below the level of the past medium-term period (see Figure 1), but was still about 2 percentage points above the EUR-12 average.

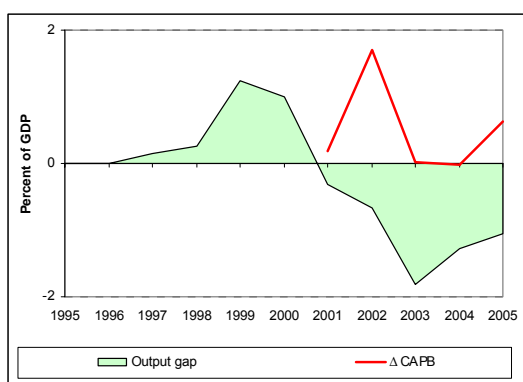
As the country was strained towards the end of the nineties, with inflationary pressures building up and the fiscal balance deteriorating, stabilisation policies have been put in place to remedy the imbalances.

Fiscal policy responded as the output gap turned negative. While structural efforts in bringing down the deficits were more significant in the period from 2001 up to 2003, when the output gap was widening, the general government deficit reductions in 2004 and 2005 were largely facilitated by the more favourable macroeconomic situation. Given that the public finance strategy is traditionally underpinned by conservative

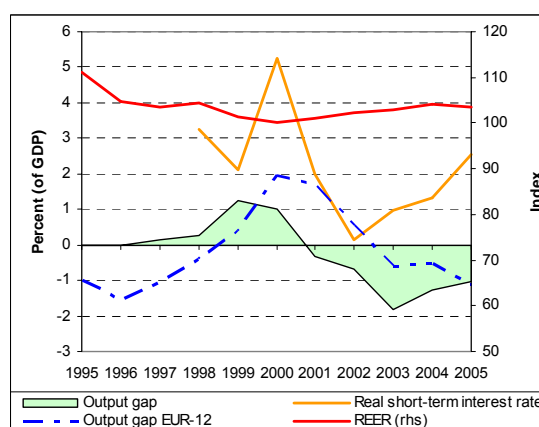
budgetary projections and may use effective mechanisms to avoid budgetary slippages, the pro-cyclical bias has been limited.

Since 2000, inflation has been the main issue of policy concern. Still in double-digit numbers until 1996, the annual inflation rate dropped to just above 6% by 1999. However, external inflationary impulses compounded by the consequences of VAT introduction a year before, disturbed the disinflationary path and took consumer price inflation (HICP) back up to 9% in 2000. Increases in administered prices, taxes and energy prices kept inflation high while the policy of steady exchange rate depreciation further added to inflation inertia. In 2003, the government assured a grip over the increase of administered prices and tax rises, de-indexation of the economy and restrictive wage policy. The Bank of Slovenia followed by slowing the rate of depreciation of the currency in the second half of 2004 before setting it at the central parity of 239.640 tolar per 1 euro with a standard fluctuation band of +/- 15 percent within ERM II on 28 June 2004. This halted a long period of continuous depreciation against the euro and the tolar has remained very stable until it was irrevocably fixed at the central parity in July 2006.

**Figure 5: Output gap and fiscal stance**



**Figure 6: Output gap and monetary conditions**



Note:  
ΔCAPB denotes the change in the cyclically-adjusted primary budget balance

Source:  
Commission services

Source: Commission services

## 2.4. Public finances

Slovenia's public finances have been broadly sound. In 1997, the general government balance slipped and stayed negative since then, but the deficits have been relatively contained. Over the 2000-2005 period, the general government deficit averaged 2.9% of GDP. The deficit reached a high of 4.3% of GDP in 2001 after the general government expenditure had been revised upwards based on court rulings<sup>8</sup> on the recognition of war claims to be paid by the Restitution Fund.<sup>9</sup> The deficit dropped below the 3% of GDP

<sup>8</sup> According to ESA95 rules, the recognition of liabilities by a court ruling should be recorded as expenditure (capital transfer, more specifically) at the time of the legal decision, irrespective of the timing for effective cash payment.

<sup>9</sup> The Restitution Fund is a government body for restitution of nationalised and confiscated properties to the original owners before the second world war and for compensation of damages to war and post-war victims.

threshold in 2002 and has progressively declined. In 2005, fiscal consolidation was on track with the general government deficit standing at 1.4% of GDP, well below the anticipated deficit of 2.1% as forecast in the January 2005 update of the convergence programme and also lower in comparison with the initial target of 1.8% of GDP, set in the May 2004 convergence programme.

While the decline of the deficit has been facilitated by an economic upturn, budgetary consolidation has progressed thanks to a reinforced commitment to fiscal discipline. In December 2001 Slovenia started adopting budgets for two consecutive years simultaneously, which seems to have encouraged fiscal prudence. Furthermore, to safeguard the budgetary targets in the face of uncertainties in the macroeconomic conditions, the Implementation Bill attached to the 2004 budget gave discretion to the government to react to an unexpected revenue shortfall within the thresholds set in the bill by suspending new spending commitments. The mechanism was successfully applied in October 2004 to buffer the negative fiscal impact of a substantial loss in VAT resources, following the dismantling of border controls after EU accession.

The consolidation path as assumed in the successive programmes seems to suggest a reasonable degree of stability as well as a satisfactory performance of the budgetary planning, taking account of the impact of comprehensive statistical revisions on the budget.<sup>10</sup>

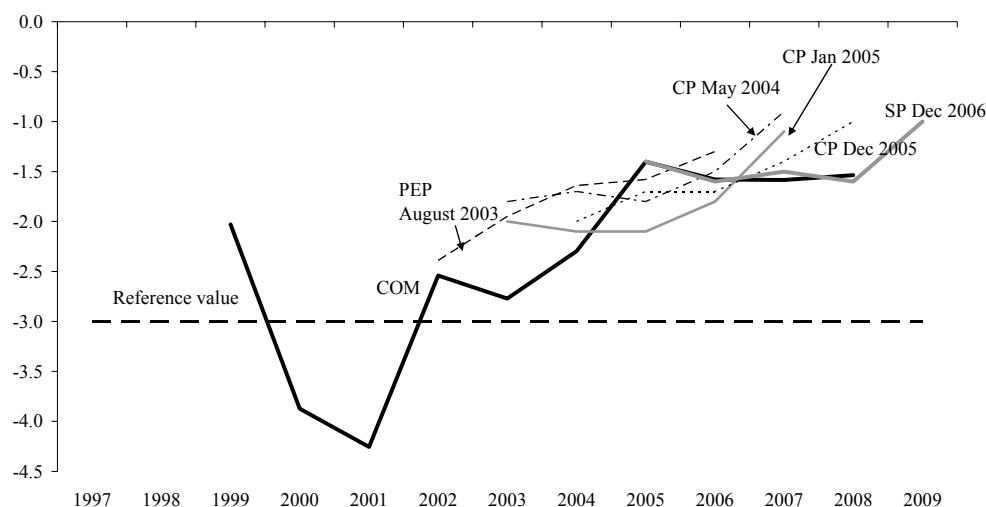
The gradual fiscal consolidation was accompanied by a progressive restructuring of general government revenues and expenditure in order to enhance budgetary flexibility. Since 2000, revenues rose slowly relative to GDP, increasing from 44.3% of GDP in 2000 to 45.5% in 2005. The expenditure ratio, on the other hand, inched down, from 48.1% of GDP in 2000 to 47.2% in 2005 mainly thanks to lower interest payments. The speed of fiscal adjustment was constrained by the high share of mandatory spending, which amounts to more than three quarters of the overall outlays. The share of investment spending remained at around 3 % of GDP (i.e. similar to public investment in the EUR-12 countries but lower than in most EUR-10 Member States) over the entire period, justified by the need to improve infrastructure and business environment in order to underpin the catching-up in economic development. The need to bolster competitiveness of the Slovene industry has prompted adjustments in the direct tax regime and the payroll tax, as a means to ease the tax burden on labour. Nevertheless, the total share of taxes and social contributions to GDP has been increasing since 2000 and is now almost 41%, slightly above the EU average.

The general government debt has been lingering at just below 30% of GDP since 2000. At the end of 2005, the gross debt accounted for 28% of GDP, down from 28.7% in 2004. In the long run, however, Slovenia faces considerable risks of budgetary imbalances due to an ageing population, which threaten to undermine the sustainability of public finances.

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<sup>10</sup> Since 2004, the government accounting system has undergone three major revisions in the framework of methodological adjustments to ESA95.

**Figure 7: General government balance projections in successive convergence/stability programmes (% of GDP)**



*Source:*  
Commission services and national stability/convergence programmes

## 2.5. Medium and long-term policy challenges for public finances

Over the last decade, the Slovene economy has been remarkably stable. The absence of any major imbalances testifies to the strength of the economy and soundness to deal with economic shocks. However, the introduction of the euro will put the robustness and flexibility of markets to the test. In particular, inflation was brought down, but price developments need to be closely monitored although wage pressures are expected to stay contained based on the recent pay agreements for both the public and the private sector. The labour market developments have generally been positive but a few structural shortcomings remain, as evidenced, in particular, by low employment of older workers. Job creation could have benefited from further measures to improve the business environment, encourage R&D activities and foster active ageing.

Against this background, the Slovene economy faces the following challenges:

**Stabilisation:** The relatively favourable macroeconomic conditions in the medium-term, with the economy growing above potential, offer the opportunity to proceed with fiscal adjustment so as to create more leeway for reacting to cyclical downturns in the future.

**Sustainability:** Although the general government debt accounted for less than 30% of GDP at the end of 2005, Slovenia appears to be at a high risk with respect to the long-term sustainability of public finances on grounds of the projected budgetary costs of population ageing in the next decades. Further measures to the ongoing pension reform will be needed to bear the cost of demographic changes.

**Efficiency:** To further advance real convergence it will be necessary to enhance the quality of public finances to help reduce the structural rigidities, improve the business climate and bolster competitiveness. While a comprehensive reform of the tax system has



been carried out the need to increase government expenditure flexibility remains largely unaddressed; the share of non-discretionary spending commitments remains more than 80% of the general government outlays.

**Table 1: Key economic indicators**

	Slovenia						EUR-12					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96-'05	'96-'00	'01-'05				'96-'05	'96-'00	'01-'05			
<b>Economic activity</b>												
Real GDP (% change)	3.9	4.4	3.4	2.7	4.4	4.0	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
<i>Domestic demand</i>	3.9	4.8	3.0	4.6	4.9	2.0	2.0	2.7	1.3	1.4	1.8	1.6
<i>Net exports</i>	0.0	-0.4	0.5	-2.0	-0.5	2.0	0.1	0.1	0.1	-0.7	0.2	-0.2
<b>Prices, costs and labour market</b>												
HICP inflation (% change)	6.9	8.2	5.6	5.7	3.7	2.5	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	3.9	4.8	3.0	3.1	3.9	3.7	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	3.9	4.8	3.0	3.1	3.9	3.7	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	0.0	-0.4	0.5	-0.4	0.5	0.3	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	6.7	7.0	6.4	6.7	6.3	6.5	9.1	9.8	8.5	8.7	8.9	8.6
<b>Competitiveness and external position</b>												
Real effective exchange rate (% change) (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	1.5	-0.7	3.7	-1.2	4.4	4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-1.2	-2.2	-0.2	-0.1	-1.2	-0.5	1.9	1.7	2.0	2.1	2.1	1.5
<b>Public finances</b>												
General government balance (% of GDP)	n.a.	n.a.	-2.7	-2.8	-2.3	-1.4	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	25.9	23.3	28.5	28.5	28.7	28.0	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-2.0	-1.7	-0.9	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
<b>Financial indicators (4)</b>												
Long term real interest rate (%) (5)	n.a.	n.a.	n.a.	0.6	1.3	2.3	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	10.8	11.7	22.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	18.4	14.9	17.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

**Notes:**

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

**Source:**

Commission services

### **3. MACROECONOMIC OUTLOOK**

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic ‘good’ or ‘bad’ times.

#### **3.1. External assumptions**

Anticipating a gradual tempering of the recent economic revival in the international environment, the external economic assumptions broadly correspond to those underlying the Commission services' autumn 2006 forecasts. The programme, however, duly notes that the oil price assumption for 2007 and 2008, set at US-Dollar 73 per barrel, is on the high side of the projection range due to the forecasts having to be finalised by end September, in line with the requirements of the budgetary procedure.

#### **3.2. Economic activity**

The macroeconomic scenario underlying the programme anticipates real GDP growth to stay robust at above 4%, thriving on a vigorous export expansion. It is broadly in line with the Commission services' autumn 2006 forecast, which foresaw real GDP growth to decelerate from close to 5% in 2006 to just above 4% as of 2007, slightly exceeding potential output growth (estimated at 4%). Economic activity is to be fuelled by the sustained recovery of investment expenditure. While imports are expected to increase more moderately, a good export performance is likely to persist against the backdrop of an upbeat outlook for Slovenia's main trading partners. The contribution of foreign demand to GDP growth is projected to stay positive.

Over the programme period, cyclical conditions (as measured by the output gap calculated by the Commission services with the commonly agreed methodology on the basis of information provided in the programme) are improving steadily. The negative output gap, standing at around 1.5% of GDP in 2005, is expected to narrow further and become marginally positive from 2009. Note that in autumn the Commission services projected that the output gap would already close in 2007, while the programme envisaged the output gap (as recalculated by the Commission services using the commonly agreed methodology) to be closed only in 2008. The difference between the estimates of the size of the output gap estimates, however, is minor. The successive estimates based on programme information have been gradually converging towards the calculations consistent with the Commission services' forecasts.

**Table 2: Comparison of macroeconomic developments and forecasts**

	2006		2007		2008		2009
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	4.8	4.7	4.2	4.3	4.5	4.2	4.1
Private consumption (% change)	3.6	3.3	3.5	3.6	3.6	3.6	3.4
Gross fixed capital formation (% change)	8.1	8.6	4.8	5.5	3.9	4.5	4.5
Exports of goods and services (% change)	10.3	9.9	8.4	8.3	8.0	8.5	8.2
Imports of goods and services (% change)	8.7	9.1	7.5	7.7	7.1	7.7	7.3
<i>Contributions:</i>							
- Final domestic demand	4.5	4.5	3.7	3.8	3.5	3.6	3.4
- Change in inventories	-0.7	-0.4	0.0	0.0	0.3	0.0	0.0
- External balance on g&s	0.9	0.6	0.6	0.5	0.6	0.6	0.7
Output gap <sup>1</sup>	-0.3	-0.5	0.0	-0.3	0.4	-0.1	0.3
Employment (% change)	0.8	0.9	0.4	0.8	0.5	0.9	0.7
Unemployment rate (%)	6.1	6.4	6.1	6.4	6.0	6.4	6.3
Labour productivity growth (%)	4.0	3.8	3.8	3.5	3.9	3.2	3.4
HICP inflation (%)	2.5	2.7	2.5	2.7	2.6	2.5	2.2
GDP deflator (% change)	1.6	1.8	3.3	3.1	2.6	2.5	2.1
Comp. of employees (% change)	6.4	5.9	6.3	6.1	6.4	6.4	6.2
Real unit labour costs (% change)	-0.2	-1.6	-1.3	-2.2	-0.7	-1.2	-0.8
External balance (% of GDP)	-2.1	-	-2.0	-	-1.6	-	-
<i>Note:</i>							
<sup>1</sup> In percent of potential GDP, with potential GDP growth as reported in Table 4 below.							
<i>Source:</i>							
<i>Commission services' autumn 2006 economic forecasts (COM); Stability programme</i>							

**Table 3: Output gap estimates in successive Commission services' forecasts and convergence/stability programmes**

	2006		2007		2008	
	COM	CP/SP	COM	CP/SP	COM	CP/SP
SP Dec 2006	-	-0.5	-	-0.3	-	-0.1
Autumn 2006	-0.3	-	0.0	-	0.4	-
Spring 2006	-0.3	-	0.1	-	-	-
CP Dec 2005	-	-0.7	-	-0.3	-	0.0
Autumn 2005	-0.5	-	0.2	-	-	-
Spring 2005	0.2	-	-	-	-	-
CP Jan. 2005	-	-1.3	-	-1.3	-	-
<i>Note:</i> Commission services' calculations according to the the commonly agreed method based on the figures of the programme						
<i>Source:</i> <i>Commission services' forecasts and national convergence/stability programme</i>						

According to the latest estimates, the economy's potential output growth is 4%, whereby the capital accumulation remains the main driving force. At the same time, the labour content of economic growth increases as the effects of the labour market reforms, currently underway, begin to unfold.

**Table 4: Sources of potential output growth**

	2006		2007		2008		2009
	COM	SP <sup>2</sup>	COM	SP <sup>2</sup>	COM	SP <sup>2</sup>	SP <sup>2</sup>
Potential GDP growth <sup>1</sup>	4.0	3.9	4.0	3.9	4.0	4.0	3.8
<i>Contributions:</i>							
- Labour	0.4	0.3	0.4	0.4	0.5	0.5	0.3
- Capital accumulation	2.0	2.1	2.0	2.0	1.9	2.0	1.9
- TFP	1.5	1.5	1.5	1.5	1.5	1.5	1.5
<i>Notes:</i>							
<sup>1</sup> based on the production function method for calculating potential output growth							
<sup>2</sup> Commission services' calculations on the basis of the information in the programme							
<i>Source:</i>							
<i>Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations</i>							

### 3.3. Labour market developments

In line with the programme's projection of favourable cyclical conditions, the positive labour market developments are expected to endure. Against the background of solid economic activity, employment continues to increase steadily. The unemployment rate, on the other hand, is forecast to settle at around 6.5% due to the remaining structural rigidities in the labour market. In particular, the skills mismatch hinders the employability of low-skilled older workers threatened by industrial restructuring.

### 3.4. Costs and price developments

Inflation is projected to stay stable at around 2.5% throughout the programme period, broadly in line with the Commission services' autumn 2006 forecast until 2008. This projection assumes the continuation of anti-inflationary policies based on prudence in administering regulated prices and a renewed commitment to wage moderation beyond 2006 agreed between social partners while the government remains bound to the accession agreement, requiring harmonisation of excise duties on tobacco with the EU legislation. The forecast, however, is vulnerable to the liberalisation of the electricity and natural gas market for households due by 1 July 2007. Moreover, there are uncertainties related to the potential increase in VAT rates, which could add up to 0.6 percentage points to the rate of inflation, according to the programme.

### 3.5. Sectoral balances

Despite having recorded a current account deficit of above 2% of GDP since 2004 Slovenia's external position appears relatively sound. The risks faced by catching-up countries (due to rallying imports, following a hike in domestic demand or a credit boom on the back of falling interest rates) have proven contained and are likely to remain so in the future. The programme anticipates the external balance deficit to decline<sup>11</sup> over the programme horizon thanks to the net inflows from the EU budget.

<sup>11</sup> No concrete figures are available as optional data on the sectoral balances has not been included.

### **3.6. Assessment**

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic ‘good’ or ‘bad’ times.

#### *3.6.1. Plausibility of the macroeconomic scenario*

The growth path underlying the macroeconomic scenario (see Table 2) appears plausible. Overall, the programme’s growth projections closely correspond to the Commission services’ autumn 2006 real GDP forecast for the period 2006-2008 and are broadly in line with the Commission services’ estimate of potential GDP growth thereafter.

#### *3.6.2. Economic good vs. bad times*

Throughout the programme period, real GDP is projected to grow at rates above potential output growth estimated by Commission services according to the agreed methodology on the basis of the information in the programme. Given that the negative output gap has been narrowing since 2004 and is expected to turn marginally positive from 2007, the broad economic outlook can be considered as an indication of economic good times over the medium-term.

## **4. GENERAL GOVERNMENT BALANCE**

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new programme, including the programme’s medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country’s position in relation to the budgetary objectives of the Stability and Growth Pact.

### **4.1. Budgetary implementation in 2006**

In 2006, the general government deficit is estimated to have deteriorated slightly compared to 2005. The preliminary outcome of 1.6% of GDP is broadly in line with the target of 1.7% of GDP, set in the December 2005 convergence programme.

A number of cost-saving measures related to rationalisation of government procurement have been endorsed in the second half of 2006, in addition to the ongoing restrictive employment and wage policies in the public sector. These expenditure measures have been designed in response to the estimated cost of the changes in the tax system, enacted at the end of November 2005 and in force from 1 January 2006. While the government estimates had shown a neutral impact of the additional simplifications of the revamped direct tax regime<sup>12</sup>, the lowering of the payroll tax rate by 20% – a first step towards its gradual abolition by 2009 (also adopted in November 2005) – was estimated to produce a revenue loss of 0.2% of GDP. Given the favourable economic trends throughout 2006, revenue windfalls channelled mainly through the capital income tax, are though expected to partly compensate for the loss generated by the tax regime adjustments.

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<sup>12</sup> To recall, the new direct tax regime is effective as of January 2005. The personal income tax was adjusted so as to provide tax relief to the lowest income classes while changes in corporate income tax included a broadening of the tax base and the elimination of loopholes in the legislation.

On the basis of developments until September, the Commission services' autumn 2006 forecast foresaw a deficit of 1.6% of GDP, implying a slight widening of the deficit compared to 2005. Based on the assumption that the expenditure measures would fall short of counterbalancing the revenue loss from phasing-out of the payroll tax; the structural balance was expected to deteriorate by ½% of GDP (see Table 7 below).

**Table 5: Evolution of budgetary targets in successive programmes**

		2005	2006	2007	2008	2009
General government balance (% of GDP)	<b>SP Dec 2006</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.0</b>
	CP Dec 2005	-1.7	-1.7	-1.4	-1.0	n.a.
	CP Jan 2005	-2.1	-1.8	-1.1	n.a.	n.a.
	COM Nov 2006	-1.4	-1.6	-1.6	-1.5	n.a.
General government expenditure (% of GDP)	<b>SP Dec 2006</b>	<b>47.2</b>	<b>46.6</b>	<b>45.1</b>	<b>44.4</b>	<b>42.6</b>
	CP Dec 2005	46.7	46.1	45.4	44.2	n.a.
	CP Jan 2005	48.0	47.4	47.4	n.a.	n.a.
	COM Nov 2006	47.2	48.0	47.0	46.4	n.a.
General government revenues (% of GDP)	<b>SP Dec 2006</b>	<b>45.8</b>	<b>45.1</b>	<b>43.6</b>	<b>42.7</b>	<b>41.7</b>
	CP Dec 2005	44.9	44.4	44.0	43.1	n.a.
	CP Jan 2005	46.0	45.6	46.3	n.a.	n.a.
	COM Nov 2006	45.8	46.4	45.4	44.8	n.a.
Real GDP (% change)	<b>SP Dec 2006</b>	<b>4.0</b>	<b>4.7</b>	<b>4.3</b>	<b>4.2</b>	<b>4.1</b>
	CP Dec 2005	3.9	4.0	4.0	3.8	n.a.
	CP Jan 2005	3.8	3.9	4.0	n.a.	n.a.
	COM Nov 2006	4.0	4.8	4.2	4.5	n.a.
<i>Source:</i>						
<i>Convergence/stability programme; Commission services' autumn 2006 economic forecasts (COM)</i>						

## 4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

### 4.2.1. The main goal of the programme's budgetary strategy

With the improvement of the quality of public finances as one of the key economic priorities, the programme gears the fiscal consolidation to achieving the medium-term objective (MTO) for the budgetary position (a structural balance of 1% of GDP) by the end of the programme period (see also Section 4.2.3). The general government deficit is planned to be reduced from 1.6% of GDP in 2006 to 1.0% of GDP in 2009.

In the programme, the consolidation path remains back-loaded while the pace of adjustment has been slowed despite a more favourable macroeconomic scenario compared with the previous programme. In the beginning of the programme period, the general government deficit is expected to linger at 1.6% of GDP and finally decrease to 1.0% of GDP in 2009. The primary balance is expected to initially slightly deteriorate, turning marginally negative (-0.1% of GDP) in 2007, followed by a further worsening to -0.3% of GDP in 2008. By 2009, the primary balance is expected to rise to 0.3% of GDP. Over the period 2006-2009, the general government deficit decreases by 0.6 percentage

points of GDP, largely as a consequence of savings in interest expenditure (0.4 percentage point of GDP) as well as the closing of the output gap.

**Table 6: Composition of the budgetary adjustment**

(% of GDP)	2005	2006	2007	2008	2009	Change: 2009-2006
<b>Revenues</b>	45.8	45.1	43.6	42.7	41.7	<b>-3.4</b>
<i>of which:</i>						
- Taxes & social contributions	40.4	39.8	38.7	38.0	37.4	<b>-2.4</b>
- Other (residual)	5.4	5.3	4.9	4.7	4.3	<b>-1.0</b>
<b>Expenditure</b>	47.2	46.6	45.1	44.4	42.6	<b>-4.0</b>
<i>of which:</i>						
- Primary expenditure	45.4	44.9	43.7	43.1	41.3	<b>-3.6</b>
<i>of which:</i>						
Consumption	22.1	22.2	21.9	21.8	20.8	<b>-1.4</b>
Transfers other than in kind & subsidies	17.6	17.4	16.8	16.7	16.4	<b>-1.0</b>
Gross fixed capital formation	3.3	3.4	3.2	2.7	2.5	<b>-0.9</b>
Other (residual)	2.4	1.9	1.8	1.9	1.6	<b>-0.3</b>
- Interest expenditure	1.8	1.7	1.4	1.3	1.3	<b>-0.4</b>
<b>General government balance (GGB)</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.0</b>	<b>0.6</b>
<b>Primary balance</b>	<b>0.4</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.3</b>	<b>0.3</b>	<b>0.2</b>
One-offs <sup>1</sup>	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.5</b>	<b>-1.6</b>	<b>-1.0</b>	<b>0.6</b>
<i>Note:</i>						
<sup>1</sup> One-off and other temporary measures.						
<i>Source:</i>						
<i>Stability programme update; Commission services' calculations</i>						

#### 4.2.2. The composition of the budgetary adjustment

The deficit reduction reflects a decline in the share of expenditure as a percentage of GDP by 4 percentage points (of which 0.4 percentage point due to savings in interest expenditure), which more than compensates for a drop in the revenue ratio by 3.4 percentage points of GDP based on the recently adopted tax reform.

The substantial decline in the revenue ratio over the programme period is due to a comprehensive tax reform, which began in 2005. In November 2006, parliament approved seven new tax laws introducing considerable modifications to the tax system as of 1 January 2007 (see Box 2). To compensate for the ensuing revenue loss, a number of expenditure measures have been adopted. The measures improve the quality of public finances but the consolidation effort remains rather limited.

The budgetary strategy is designed to support the goal of catching-up with the average EU income levels. In this context, the authorities plan important public investment over the programme horizon, notably a major investment in the railway infrastructure, which is estimated to have a deficit-increasing impact of 0.4% of GDP in 2007, 0.5% of GDP in 2008 and 0.2% of GDP in 2009. However, over the period as a whole, the share of public investment in GDP falls by almost 1 percentage point.



## Box 2: The budget for 2007

According to the existing budgetary procedure of simultaneously adopting budgets for two consecutive years, the original 2007 budget was adopted in December 2005. In line with the procedure, the government presented the supplementary 2007 budget to parliament in October 2006, together with the 2008 budget. Subjected to a two month scrutiny by parliament and following a number of amendments, the 2007 Budget Bill and the accompanying Budget Implementation Act were passed together with the 2008 budget on 20 November 2006.

The 2007 budget targets a general government deficit of 1.6% of GDP. On the revenue side, the new changes to the personal income and corporate income tax regimes adopted by Parliament in November 2006 have been duly included. Although only effective since 1 January 2005, with further simplifications taking effect from 1 January 2006, the direct tax regime has been widely perceived as insufficient to serve the aim of enhancing the competitiveness and growth potential of the Slovene economy. The new personal income tax reform to come into effect as of 2007 curbs taxation progression by reducing the number of tax brackets from five to three and capping the top tax rate at 41% (previously 50%). Similarly, the new corporate income tax regime lowers the tax rate from 25% to 23% in 2007 – followed by a 1 percentage point cut each year to reach 20% by 2010 – while abolishing investment expenditure as tax exemptions except for R&D-related spending. Moreover, in the framework of a gradual elimination of the payroll tax by 2009, its rate is lowered by a further 40%. To recall, the payroll tax rate is being reduced gradually, starting in 2006 by a 20% cut, followed by 40% in 2007, 70% in 2008, and should disappear by 2009.

On the expenditure side, cost-saving measures related to the ongoing rationalisation of government goods and services purchases as well as restrictive employment and wage policies in the public sector, have been included. The reform of social and unemployment benefits, increasing conditionality and streamlining the indexation mechanism, will contain the rise of social transfers. The measures enhancing cost effectiveness and flexibility, however, will be partly offset by the decision to index pensions to wages. Furthermore, spending commitments related to EU and NATO membership (e.g. Schengen border, top-up payments related to the farming sector, defence) weigh on the budget.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"><li>○ Lowering the payroll tax rate by 40% (-0.4% of GDP)</li><li>○ The new personal income tax (-0.5% of GDP)</li><li>○ The new corporate income tax (-0.3% of GDP)</li><li>○ Harmonisation of excise duties with the <i>acquis</i> (0.1% of GDP)</li></ul>	<ul style="list-style-type: none"><li>○ Restrictive employment policy (-0.2% of GDP)</li><li>○ Indexation of pensions to wages (0.1% of GDP)</li><li>○ Improvement of public procurement (-0.1% of GDP)</li><li>○ Streamlining of indexation of social transfers (-0.4% of GDP)</li><li>○ Railway investment (0.4% of GDP)</li></ul>

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

Sources: Commission services and stability programme.

### 4.2.3. The medium-term objective (MTO) and the structural adjustment

According to the stability programme, the MTO is set at a structural deficit of 1.0% of GDP and planned to be achieved by 2009. This is a postponement by one year compared to the previous programme. The MTO satisfies the condition of providing a safety margin (most recent estimate of the minimum benchmark is a cyclically-adjusted deficit

of 1½% of GDP) and, for euro area and ERM II countries, respects the lower bound of a structural deficit of 1% of GDP. It is considered appropriate in view of the debt ratio and average potential growth in the long run.

**Box 3: The medium-term objective (MTO) for the budgetary position**

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

Based on Commission services' calculations according to the commonly agreed methodology and consistent with the information in the programme, the structural balance is estimated to have stood at -1.4% of GDP in 2006. Following a slight deterioration to -1.6% of GDP in 2008, the structural balance is expected to improve in 2009, when the structural deficit is expected to be reduced to 1.1% of GDP. The structural balance<sup>13</sup> is thus envisaged to improve by mere ¼ percentage point of GDP over the programme horizon whereby the adjustment is entirely back-loaded.

In primary terms though, the structural balance deteriorates by ¼ percentage point of GDP until 2009, when an improvement of around ½ percentage point is anticipated. In light of a declining interest burden, the structural position worsens by some 0.2% of GDP between 2006 and 2009. The implied fiscal stance is considered as mildly expansionary to neutral in 2007 and 2008 and restrictive in 2009.

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<sup>13</sup> As estimates of potential growth, also cyclically-adjusted and structural balances need to be interpreted with caution for countries like Slovenia.

**Table 7: Output gaps and cyclically-adjusted and structural balances**

% of GDP	2005		2006		2007		2008		2009	Change: 2009-2006
	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	SP <sup>1</sup>	SP <sup>1</sup>
Gen. gov't balance	-1.4	-1.4	-1.6	-1.6	-1.6	-1.5	-1.5	-1.6	-1.0	0.6
One-offs <sup>2</sup>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Output gap <sup>3</sup>	-1.1	-1.2	-0.3	-0.5	0.0	-0.3	0.4	-0.1	0.3	0.9
CAB <sup>4</sup>	-0.9	-0.9	-1.5	-1.4	-1.6	-1.4	-1.7	-1.6	-1.1	0.2
change in CAB	0.8	:	-0.5	-0.5	-0.1	0.0	-0.2	-0.2	0.4	:
CAPB <sup>4</sup>	0.7	0.9	0.1	0.3	-0.2	0.0	-0.4	-0.3	0.2	-0.2
Structural balance <sup>5</sup>	-0.9	-0.9	-1.5	-1.4	-1.6	-1.4	-1.7	-1.6	-1.1	0.2
change in struct. bal.	0.8	:	-0.5	-0.5	-0.1	0.0	-0.2	-0.2	0.4	:
Struct. prim. bal. <sup>6</sup>	0.7	0.9	0.1	0.3	-0.2	0.0	-0.4	-0.3	0.2	-0.2

Notes:

<sup>1</sup>Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme

<sup>2</sup>One-off and other temporary measures. See Table 6 above.

<sup>3</sup>In percent of potential GDP. See Table 2 above.

<sup>4</sup>CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.

<sup>5</sup>CAB excluding one-off and other temporary measures

<sup>6</sup>Structural primary balance = CAPB excluding one-off and other temporary measures

Source :  
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

### 4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors.

As mentioned in Section 3.7.1, the macroeconomic scenario underlying the budgetary projections is plausible. Sensitivity of fiscal projections to several negative shocks is analysed in the programme, as requested by the code of conduct. Shocks to five key economic variables have been tested for the budgetary impact: i) lower real GDP growth in the previous year, ii) poor conditions on the labour market (resulting in no employment growth), iii) wage moderation (modelled by average wage growth which is by 1 percentage point lower), iv) withering consumers' confidence (channelled through a decrease in private consumption by 1 percentage point), and v) lower government consumption by 1 percentage points. With a negative effect of at most 0.26% of GDP the government deficit did not prove very responsive to downside risks. However, the programme does not dwell on the underlying assumptions about how revenue and expenditure are projected to react to variations in economic variables.

The programme anticipates a significant revenue loss throughout the programme period, due mainly to the recent tax reform, which was designed to enhance the efficiency of general government revenue while, at the same time, reducing the tax burden on both capital and labour. Measures related to the tax cuts to be carried out over the programme period are well described. The tax revenue projections embody plausible assumptions, which may well prove conservative in light of the Commission services' assessment presented in the autumn forecast estimating the composition of economic growth more tax-favourable in both 2007 and 2008. However, the negative impact of the tax cuts on the budget might possibly be underestimated in the programme.

On the other hand, not all expenditure measures which are supposed to offset the impact of the tax cuts on the budget balance in 2007 and 2008 (and exceed it in 2009), are clear. In particular, the measures planned for 2009, when primary expenditure is scheduled to fall by almost 2 percent of GDP, remain to be specified in detail. Taking corrective measures of the scale envisaged in the programme will be challenging in the face of political risks related to measures in the social area.<sup>14</sup> The high share of mandatory expenditure (more than 80% of the overall outlays), which awaits to be restructured in a more flexible way, requires a more resolute political action.

On the positive side, Slovenia has established a track record of better-than-projected budgetary outcomes in the recent years. A careful fiscal targeting is supported by an effective mechanism of containing general government expenditures in response to an unexpected revenue shortfall. Since 2000, the legal framework allows the government to safeguard the deficit target in case economic conditions impinge on public finances.

Concluding, the programme features budgetary projections where the risks to the targets are broadly balanced until 2008. In 2009 however the outcome could be worse as the expenditure restraint is not well specified.

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<sup>14</sup> Social partners have been fiercely opposing the socio-economic reform agenda with the argument that certain measures would considerably undermine the social conditions of a large part of the population. In particular, the idea of introducing the flat tax rate has been abandoned under heavy criticisms, voiced over a number of public debates in 2006.

**Table 8: Comparison of budgetary developments and projections**

(% of GDP)	2005	2006		2007		2008		2009
		COM	SP	COM	SP	COM <sup>1</sup>	SP	SP
<b>Revenues</b>	45.8	46.4	45.1	45.4	43.6	44.8	42.7	41.7
<i>of which:</i>								
- Taxes & social contributions	40.4	40.7	39.8	40.0	38.7	39.6	38.0	37.4
- Other (residual)	5.3	5.8	5.3	5.4	4.9	5.2	4.7	4.3
<b>Expenditure</b>	47.2	48.0	46.6	47.0	45.1	46.4	44.4	42.6
<i>of which:</i>								
- Primary expenditure	45.5	46.5	44.9	45.6	43.7	45.1	43.1	41.3
<i>of which:</i>								
Consumption	19.6	19.5	22.2	19.2	21.9	19.1	21.8	20.8
Transfers other than in kind & subsidies	17.9	18.1	17.4	17.4	16.8	16.9	16.7	16.4
Gross fixed capital formation	3.6	3.8	3.4	3.9	3.2	3.8	2.7	2.5
Other (residual)	4.4	5.1	1.9	5.1	1.8	5.3	1.9	1.6
- Interest expenditure	1.7	1.5	1.7	1.4	1.4	1.3	1.3	1.3
<b>GGB<sup>2</sup></b>	-1.4	-1.6	-1.6	-1.6	-1.5	-1.5	-1.6	-1.0
<b>Primary balance</b>	0.3	-0.1	0.1	-0.2	-0.1	-0.3	-0.3	0.3
One-offs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB<sup>2</sup> excl. one-off</b>	-1.4	-1.6	-1.6	-1.6	-1.5	-1.5	-1.6	-1.0
<b>Notes:</b>								
<sup>1</sup> On a no-policy change basis.								
<sup>2</sup> General government balance								
<i>Source:</i>								
<i>Commission services' autumn 2006 economic forecast (COM); stability/convergence programme update;</i>								
<i>Commission services' calculations</i>								

**Table 9: Assessment of tax projections**

	2007			2008			2009
	SP	COM	OECD <sup>3</sup>	SP	COM <sup>1</sup>	OECD <sup>3</sup>	SP
Change in tax-to-GDP ratio	-1.2	-0.7	0.0	-0.7	-0.4	0.0	-0.6
<i>Difference (SP – COM)</i>	-0.5		/	-0.3		/	/
<i>of which<sup>2</sup>:</i>							
- discretionary and elasticity component	0.4		/	0.2		/	/
- composition component	-0.5		/	-0.4		/	/
<i>Difference (COM - OECD)</i>	/	-0.7		/	-0.4		/
<i>of which<sup>2</sup>:</i>							
- discretionary and elasticity component	/	-0.6		/	-0.5		/
- composition component	/	0.0		/	0.2		/
p.m.: Elasticity to GDP	0.6	0.8	1.0	0.7	0.9	1.0	0.7
<u>Notes:</u>							
<sup>1</sup> On a no-policy change basis							
<sup>2</sup> The decomposition is explained in Annex 5							
<sup>3</sup> Based on OECD ex-ante elasticity relative to GDP							
<u>Source:</u>							
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							

#### 4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

**Table 10: Overview of compliance with the Stability and Growth Pact**

	Based on programme <sup>3</sup> (with targets taken at face value)	Assessment (taking into account risks to targets)
a. Safety margin against breaching 3% of GDP deficit limit <sup>1</sup>	throughout programme period	throughout programme period
b. Achievement of the MTO	broadly in 2009	possibly not within the programme period
c. Adjustment towards MTO in line with the Pact <sup>2</sup> ?	insufficient and should be strengthened	insufficient and should be strengthened
d. Temporary deviation from adjustment towards MTO <sup>4</sup>	implicit	not admissible
<u>Notes:</u>		
<sup>1</sup> The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1½% of GDP for Slovenia). These benchmarks represent estimates and as such need to be interpreted with caution.		
<sup>2</sup> The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance		

of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.

<sup>3</sup>Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

<sup>4</sup> See box 4.

Source:

*Commission services*

Taking into account the risk assessment above, the risk of breaching the 3% of GDP threshold for the deficit in any of the years covered by the programme is not imminent as a safety margin with respect to the reference value within normal cyclical fluctuations is assured (the minimum benchmark for Slovenia is a cyclically-adjusted deficit of around 1.5% of GDP).

Given the risks identified in the previous section, it is, however, questionable if the budgetary strategy outlined in the programme can ensure that the programme's MTO will be reached in 2009, as targeted.

The adjustment path towards the MTO is insufficient and should be strengthened. The improvement in the structural balance – planned to be ¼% of GDP between 2006 and 2009 – does not meet the “benchmark” of 0.5% of GDP per year, specified in the Stability and Growth Pact for the euro area and ERM-II Member States; moreover, as mentioned above, the consolidation plan is not without risk, especially in 2009, when the adjustment could be possibly lower than the 0.5% of GDP, as targeted for that year. In addition, a higher effort would be expected given the "good times" implied by the gradual improvement of the cyclical position over the programme horizon (see Section 3.7.1 for the assessment, compounded by the analysis of tax elasticities in Table 9 above).

The conditions to allow for a temporary deviation from the adjustment path towards the MTO (i.e. from the 0.5% of GDP annual structural adjustment as a benchmark for euro area and ERM II countries) set out in the code of conduct (see Box 4) are not satisfied.

#### **Box 4: Major structural reforms in the Stability and Growth Pact**

According to the Stability and Growth Pact and the code of conduct, Member States that have not yet reached their MTO can temporarily depart from the required adjustment path in case of “major structural reforms”.

Several conditions need to be met for this clause to be applicable:

1. The structural reforms that underlie the request for a temporary deviation must have a verifiable positive impact on the long-term sustainability of public finances. This includes reforms with direct long-term cost-saving effects as well as reforms raising potential growth, which have indirect effects on the public finances.
2. The claim to a temporary deviation must be supported by a detailed, comprehensive and cautious quantitative cost-benefit-analysis (to be presented in the programme) of the short- and long-term budgetary impact of the reforms.
3. The reforms must have been adopted.
4. An appropriate safety margin against breaching the 3% deficit limit should be preserved in each year.
5. For structural reforms other than systemic pension reform (of the kind that introduces a multi-pillar system including a fully-funded pillar), the budgetary position has to return to the MTO

within the period covered by the programme; in the case of systemic pension reform as meant above, the deviation should nonetheless remain temporary and the size of the deviation from the MTO should reflect the reform's impact on the general government balance.

In particular, the programme puts the departure from the annual structural adjustment benchmark in the context of the comprehensive tax reform to be carried out over the programme period. As explained in the programme, the tax measures which have or will come into effect during the programme period, are expected to produce beneficial economic effects by reducing the tax burden in the economy, thereby considerably increasing its competitiveness. The programme justifies the breach of the benchmark with the plans related to a major investment in the railway infrastructure (upgrading and constructing part of railway tracks on the TEN-T corridors V and X<sup>15</sup>). The authorities deem it a priority structural project. Between 2007 and 2009, the spending commitments related to the railway investment will worsen the general government deficit by 0.4%, 0.5% and 0.2% of GDP, respectively. At the same time, however, the public investment-to-GDP ratio is projected to fall by almost 1 percentage point over the programme period.

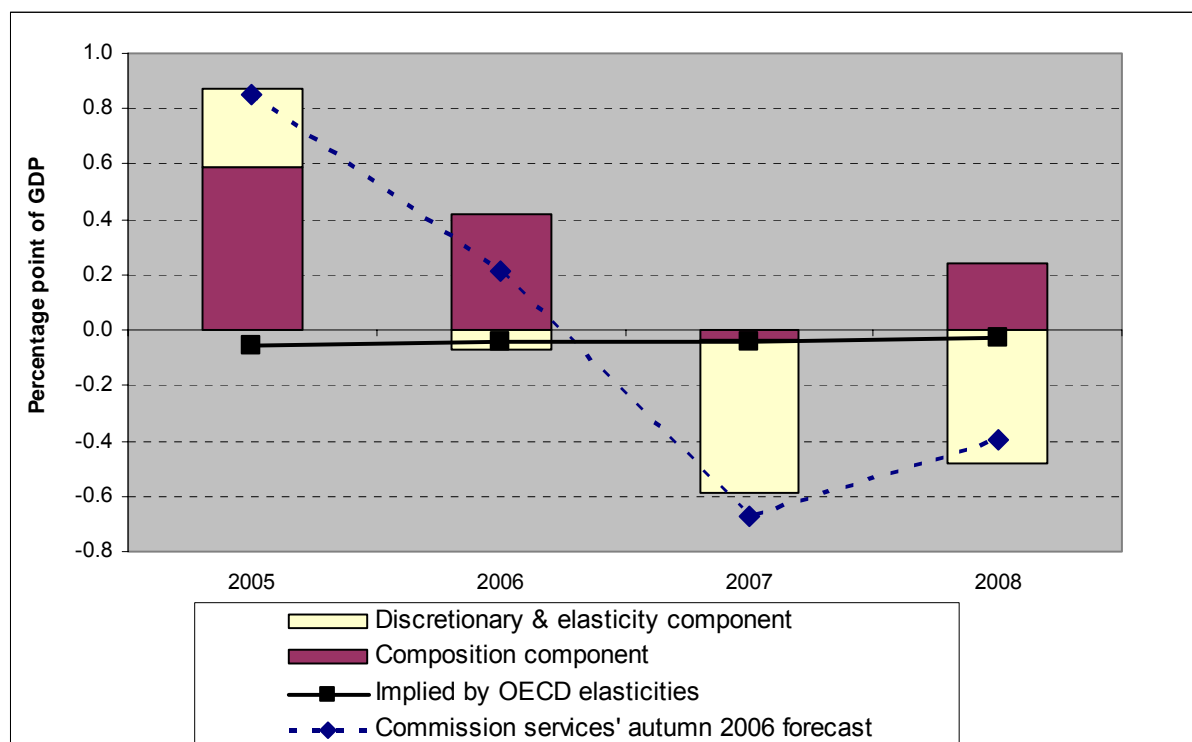
In terms of the conditions listed in box 4, it should be noted that, while the programme qualifies the railway investment project as having substantial impact on sustainable development, in particular by improving competitiveness, regional development, environment, and energy policy), the benefits for the long-term sustainability of such a structural project are in general difficult to verify. A safety margin seems to be provided throughout the programme period, but the budgetary position cannot be expected to return to the MTO within the programme period in view of the risks to the budgetary targets identified above.

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<sup>15</sup> As a part of the Trans-European Transport Network, an EU transport development initiative to enhance integration between the Member States, projects on corridors V and X mainly concern modernising the Ljubljana-Budapest line and upgrading the Divača-Koper and Trieste-Divača sections.



**Figure 8: Changes in the tax-to-GDP ratio:  
actual/projected changes vs. changes implied by OECD elasticity**



Note:

The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:

*Commission services*

## 5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.<sup>16</sup> The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programmes targets, compares them with the Commission services' forecasts and assesses the associated

<sup>16</sup> On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

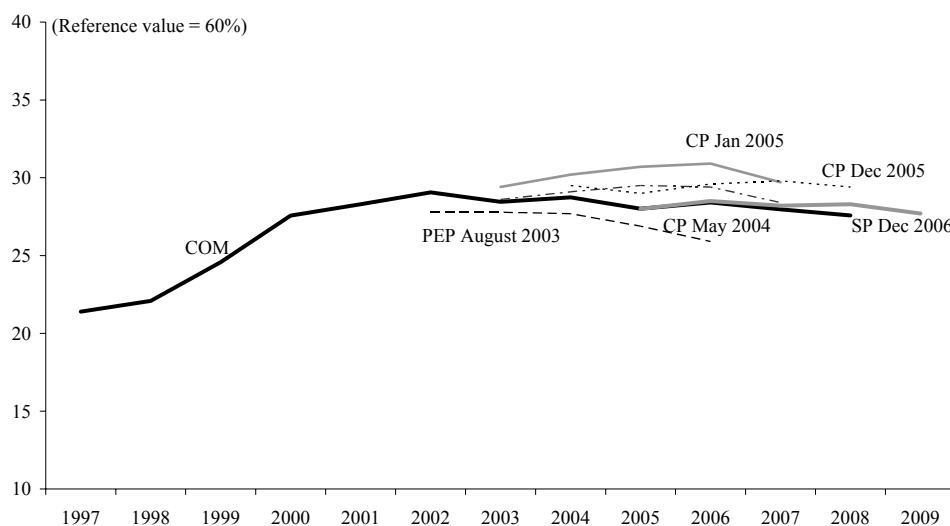
## 5.1. Recent debt developments and medium-term prospects

### 5.1.1. Debt projections in the programme

At the end of 2005, the general government debt amounted to 28% of GDP following a downward revision by 1 percentage point compared to the December 2005 convergence programme. In June 2005, the government repaid debt in the amount of 80.9 billion tolar (1.1% of GDP) by using the remaining privatisation proceeds from the sale of a 30% share in the biggest Slovene bank, the Nova Ljubljanska Banka in 2002. The new programme estimates the debt ratio to have increased to 28.5% of GDP in 2006. The preliminary outcome is in line with the Commission services' autumn 2006 forecast of 28.4% of GDP.

Over the programme horizon, the gross government debt is set to remain low and stable as a share of GDP. In 2009, the government anticipates to reduce it to 27.7% of GDP. The developments in the debt ratio are mainly influenced by the stock-flow adjustment since the contribution of the primary balance is broadly offset by the debt-decreasing snow-ball effect (as the implicit interest rate is planned to be below the nominal GDP growth rate) throughout the programme period.

**Figure 9: Debt projections in successive convergence/stability programmes (% of GDP)**



*Source: Commission services and national stability/convergence programmes*

**Table 11: Debt dynamics**

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009
			COM	SP	COM	SP	COM	SP	SP
<b>Gross debt ratio<sup>1</sup></b>	<b>28.7</b>	<b>28.0</b>	<b>28.4</b>	<b>28.5</b>	<b>28.0</b>	<b>28.2</b>	<b>27.6</b>	<b>28.3</b>	<b>27.7</b>
Change in the ratio	0.8	-0.7	0.4	0.5	-0.5	-0.3	-0.4	0.1	-0.6
<i>Contributions<sup>2</sup>:</i>									
Primary balance	0.7	-0.3	0.1	-0.1	0.2	0.1	0.3	0.3	-0.3
“Snow-ball” effect	-0.2	0.1	-0.2	0.0	-0.6	-0.6	-0.6	-0.5	-0.4
<i>Of which:</i>									
Interest expenditure	2.2	1.7	1.5	1.7	1.4	1.4	1.3	1.3	1.3
<i>Growth effect</i>	-0.9	-1.1	-1.3	-1.2	-1.1	-1.1	-1.2	-1.1	-1.1
<i>Inflation</i>	-1.6	-0.4	-0.4	-0.5	-0.9	-0.8	-0.7	-0.7	-0.6
Stock-flow adjustment	0.2	-0.6	0.5	0.6	0.0	0.2	-0.1	0.3	0.1
<i>Of which:</i>									
Cash/accruals diff.	-0.2	0.3	-	-	-	-	-	-	-
Acc. financial assets	-0.2	-1.1	-	-	-	-	-	-	-
<i>Privatisation</i>	-1.2	-1.1	-	-	-	-	-	-	-
Val. effect & residual	0.6	0.2	-	-	-	-	-	-	-
Notes:									
<sup>1</sup> End of period.									
<sup>2</sup> 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 (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the “snow-ball” effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.									
<i>Source:</i>									
<i>Stability programme (SP); Commission services’ autumn 2006 economic forecasts (COM); Commission services’ calculations</i>									

### 5.1.2. Assessment

The programme’s projections for the general government debt are close to the Commission services’ autumn 2006 forecast, which predicts the debt ratio to fall below 28% of GDP by the end of 2008 (under a no-policy change assumption).

The debt is considered not to be prone to adverse shocks. The debt portfolio remains appropriate. A long-term repayment profile spreads evenly over time, however, attention is due given that the average residual maturity has fallen from 7.2 years in 2001 to 5.6 years in 2005. Furthermore, virtually all debt is denominated in tolar or euro.<sup>17</sup> In the medium-term, the debt cost is expected to decrease with the adoption of the euro as a national currency while the government also plans to enforce a more active policy of debt management. Interest expenditure is projected to fall from 1.7% of GDP in 2005 to 1.3% of GDP by 2009.

<sup>17</sup> At the end of 2005, the government debt denominated in other currencies accounted for 0.3% of GDP.

## 5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.<sup>18</sup>

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see box 5), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2009, the final year of the stability programme; it is called the “2006 scenario”. Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2009 provided in the stability programme will be fully respected. This is the “programme scenario”. Debt and primary balance projections in this scenario start in 2010. Both scenarios assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

### 5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections.<sup>19</sup> Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

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<sup>18</sup> For a detailed analysis of long-term sustainability issues, see “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

<sup>19</sup> These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), “The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)”, European Economy, Special Report No 1 (hereinafter Ageing Report).

**Table 12: Long-term age-related expenditure: main projections**

(% of GDP)	2004	2010	2020	2030	2040	2050	changes
<b>Total age-related spending</b>	24.2	24.0	25.5	28.6	31.7	33.8	9.7
Pensions	11.0	11.1	12.3	14.4	16.8	18.3	7.3
Healthcare	6.4	6.7	7.2	7.6	7.9	8.0	1.6
Long-term care	0.9	1.1	1.3	1.5	1.9	2.2	1.2
Education	5.3	4.6	4.3	4.7	4.7	4.9	-0.4
Unemployment benefits	0.5	0.4	0.4	0.4	0.4	0.4	-0.1

*Source: Economic Policy Committee and Commission services.*

The projected increase in age-related spending in Slovenia is considerably above the average of the EU, rising by 9.7% points of GDP between 2004 and 2050. The bulk of this increase is due to the high expected increase in expenditure on pensions, projected to rise in Slovenia by 7.3% points. The increase in health-care expenditure is projected to be 1.6% points of GDP, which is also the EU average. For long-term care, the projected increase of 1.2% points up to 2050, is also above the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

**Table 13: Sustainability indicators and the required primary balance**

	2006 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	3.6	7.0	7.3	3.7	7.2	7.3
<i>of which:</i>						
Initial budgetary position	0.0	0.1	-	0.1	0.2	-
Debt requirement in 2050	-0.6	-	-	-0.6	-	-
Future changes in budgetary position	4.2	7.0	-	4.2	7.0	-

*Source: Commission services.*

Table 13 shows the sustainability indicators for the two scenarios. In the “2006 scenario”, the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 3.6% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 7.0% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are smaller in the present assessment, by about ¼ p.p. of GDP. This is mainly due to a slightly higher estimated structural primary balance in 2006 (at 0.3% of GDP) compared with the structural primary balance in 2005 estimated in spring 2006 (at 0.2% of GDP) that was used in the Sustainability Report.

The initial budgetary position is not sufficiently high to offset the considerable impact of increase in age-related expenditure up to 2050 and there is a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. The programme plans a slight weakening of a structural budgetary balance of 0.1% of GDP between 2006 and 2009, which would imply a slight increase in risks to long-term sustainability of public finances by increasing both sustainability gaps (“programme scenario”). According to both sustainability gaps, the long-term budgetary impact of ageing is relatively high.

The required primary balance (RPB) is about 7.3% of GDP, substantially higher than the structural primary balance of about 0.2% of GDP in the last year of the programme's period.

Moreover, the sustainability gap indicators would increase by 0.6% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt depending on the scenario are shown in Figure 10.

The gross debt ratio is currently well below the 60% of GDP reference value, estimated in the programme at below 30% of GDP in 2006. According to the “2006 scenario”, up to 2020, the debt ratio is projected to remain relatively stable, below 30% of GDP. It is expected to reach 60% in around 2030 and to increase significantly thereafter throughout the projections period up to 2050. A similar picture emerges in the “programme scenario”, since the structural budgetary position in 2009 is rather close to the one in 2006.<sup>20</sup>

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<sup>20</sup> It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services’ short-term forecasts, but as an indication of the risks faced by Member States.

### Box 5 – Sustainability indicators\*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden\*\*) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the: (i) **initial budgetary position (IBP)**; (ii) **long-term change in the budgetary position (LTC)**; and, (iii) **debt requirement in 2050 (DR)**.
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2010-2014) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

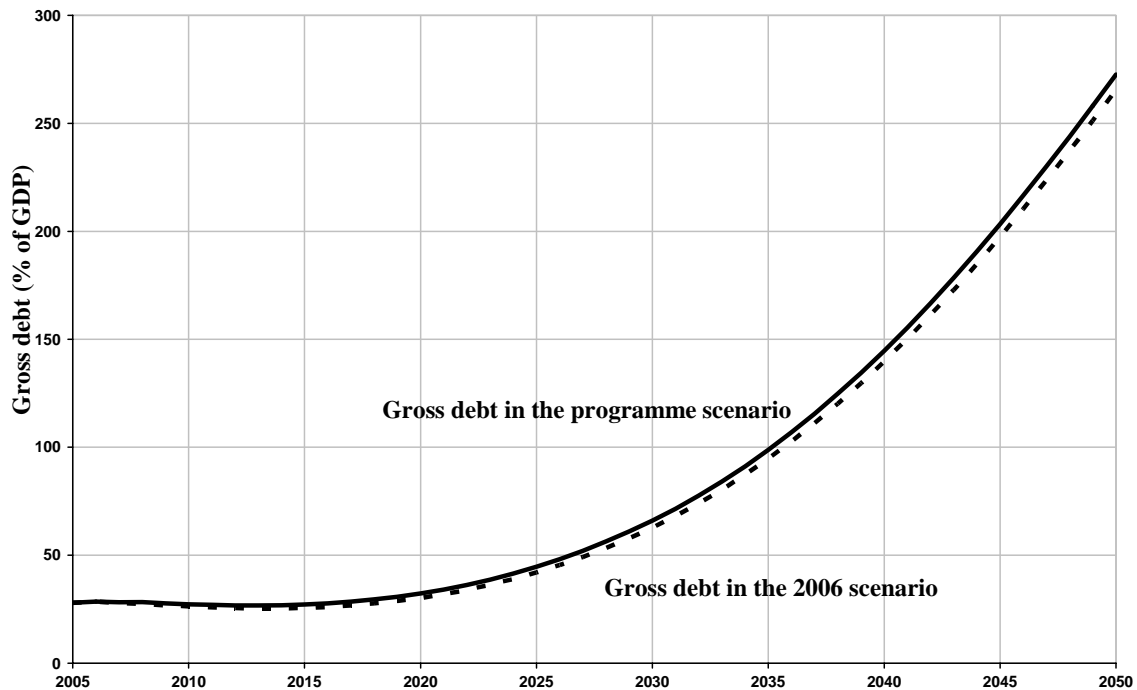
#### Summarizing the sustainability indicators

	Impact of				
	Initial budgetary position		Debt requirement in 2050		Long-term changes in the primary balance
<b>S1=</b>	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to reach a debt target of 60% of GDP in 2050	+	Additional adjustment required to finance the increase in public expenditure <i>up to 2050</i>
<b>S2=</b>	Gap to the debt-stabilizing primary balance	+	0	+	Additional adjustment required to finance the increase in public expenditure <i>over an infinite horizon</i>

\* For a complete description of the sustainability indicators, see Annex I of the “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006.

\*\* Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

**Figure 10: Long-term projections for the government debt ratio**



*Source: Commission services.*

### 5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, the long-term budgetary projections presented in the Stability programme differ from those in the Ageing Report due to:

1. more up-to-date information, taking into account the 2006 outturn and the adopted budgets for 2007-2008 and projections for 2009; and
2. the effects of the new law on indexation of social transfers according to which non age-related pensions are indexed to changes in the CPI index instead of the wage growth as it has been the case so far. The law was enacted by the Parliament in November 2006.

The difference is mainly reflected in lower projected pension and long-term care expenditures (by app. 1% and ¼% of GDP, respectively) by 2050. However, the Slovenian authorities currently project a higher increase in health-care expenditures over the long-term compared with the EPC reference scenario, by about 1% point of GDP, suggesting that the budgetary costs of ageing could be higher than in the Ageing Report. Overall, the change in the age-related expenditure as a share of GDP expenditure/GDP ratio up to 2050 in the programme is close to that of the Ageing Report (9.1% points of GDP in the programme against 9.6% points in the Ageing Report over the period 2005-2050) and would therefore not significantly change the prospects for public finance sustainability.



The programme includes also a scenario assuming alignment of the participation rates in Slovenia to those in the most advanced EU Member States by 2050. As a consequence of a larger number of employees, a lower number of pensioners and higher GDP growth, the increase in age-related expenditure would be reduced to 6.7% points of GDP over the projection period. Most of it would still be due to the increase in pension expenditures, although to a lesser degree, as this increase would be of 4.5% points of GDP. On the assumption that these additional national projections will materialise, they would imply lower sustainability risks.

The programme acknowledges that additional reform measures are necessary in order to tackle the projected budgetary burden of ageing. In this respect, the government has established a working group with the aim of designing policies to increase the employment of the elderly. In addition, the legislation concerning voluntary pension schemes is under revision in order to increase incentives to save; new measures are expected to be enacted in 2007.

### 5.2.3. *Assessment*

The long-term budgetary impact of ageing in Slovenia is among the largest in the EU, influenced notably by a considerable increase in pension expenditure as a share of GDP. While some action is being taken, implementation of further reform measures aimed at containing the substantial increase in age-related expenditures would contribute, as recognised by the authorities, to reducing risks to the sustainability of public finances.

Although the initial budgetary position contributes to stabilising the debt ratio over the medium-term, the low structural improvement over the programme horizon will not be sufficient to contain the expected budgetary impact of ageing..

Overall, Slovenia appears to be at high risk with regard to the sustainability of public finances.

## **6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES**

Having adopted the euro, Slovenia accomplished the main short-term economic objective. The key policy priorities become sustaining resilience to shocks and enhancing the flexibility of the economy while pursuing real convergence. To integrate smoothly into its new monetary environment, Slovenia confirms in the stability programme its commitment to sound policies. Inside the euro area, fiscal policy is the key instrument for maintaining macroeconomic stability. To avoid a pro-cyclical macro stance, the authorities should be ready to tighten the fiscal stance as needed. Achieving a balanced budgetary position in structural terms, the ultimate goal of the fiscal policy, should place public finances on a sustainable footing.

With the aim to integrate successfully in the euro area, the stability programme sets out a path towards a balanced budgetary position based on the reduction of public expenditure, the tax system reform, the renewal of the social agreement underpinning wage moderation and prolonged activity on the labour market.

In 2006, significant progress has been made on most of the areas underlying the fiscal consolidation. In particular, a thorough overhaul of the tax system was undertaken in order to enhance the efficiency of general government revenue while, at the same time,

reducing the tax burden on both capital and labour (see section 4.2). The risk that the tax reforms would undermine the solid budgetary position prompted the government to launch a scrutiny of general government expenditures and put forward a list of cost-saving measures. An effort was made to quantify the impact of the planned reforms on the projections of the main fiscal aggregates in the stability programme. The overall effect of reducing and restructuring the general government expenditure has been estimated to result in yearly savings, increasing from 1.5% of GDP in 2007 to 1.8% of GDP by 2009. Restructuring general government expenditure by making spending more flexible (i.e. restraining the very high share of nondiscretionary expenditure commitments, allows more room for manoeuvre to deal with the adverse cyclical conditions). At the same time, it fosters allocation of resources in support of economic growth and development.

The stability programme outlines the fiscal measures in support of creating a competitive and efficient knowledge-based society. The tax reform has been designed with the aim to boost economic growth through the promotion of innovation and technological development. Investments in research and employment creation have remained entitled to tax relief, which should encourage entrepreneurship, one of the key challenges identified by the NRP. Furthermore, increasing the share of R&D-related expenditure in the budget has been identified a policy priority. Currently accounting for 1.5% of GDP, the highest among the ten new Member States, R&D spending is to move closer to the target, set at 3% of GDP by 2010. In this context, policy action must focus especially on improving the interaction between research activities and industry.

## **7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES**

The stability programme bears a close link with the national reform programme (NRP), submitted on 16 October 2006 in the context of the renewed Lisbon strategy for growth and jobs. The stability programme briefly reviews the government's structural reform agenda as presented in the NRP. An extensive list of largely appropriate measures is based on a comprehensive approach to ensure a successful integration in the monetary union. They focus on enhancing competitiveness of the economy by improving the business environment, encouraging R&D activities, promoting job-creation-oriented investment as well as removing structural rigidities in the labour market..

The stability programme contains a qualitative assessment of the overall impact of the NRP within the medium term fiscal strategy. In addition, it provides some information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the NRP. The public finance implications of the actions envisaged in the IR-NRP are however not explicitly taken into account in the programme's budgetary projections.

### **Box 6: The Commission assessment of the implementation report of the National Reform Programme**

The implementation report of the National Reform Programme of Slovenia, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 16 October 2006. The Commission's assessment of this report, which was adopted on 13 December 2006 as part of its Annual Progress Report, can be summarised as follows.

Overall, Slovenia is making good progress in implementing its National Reform Programme, which identifies as key challenges: a competitive economy and faster growth; a knowledge-based society; an efficient state; a modern social state and higher employment; and sustainable development. Benefiting from relatively favourable macroeconomic conditions, Slovenia has taken appropriate measures in some key areas such as entrepreneurship and better regulation and has launched most of the major reforms of employment policies. However, progress on the implementation of the active ageing strategy and on the removal of barriers to youth employment has so far not been rapid enough. In the microeconomic area, stronger measures would be needed to enhance the innovation and competition framework. Greater effort would also be desirable also as regards restructuring public expenditure.

The strengths illustrated by the Implementation Report include the fiscal reform efforts and the various measures to promote entrepreneurship. Other areas where effective action has been taken include the ongoing restructuring of state funds into portfolio investors, the decreasing share of state aid in GDP and the progress towards the full liberalization of energy markets and the creation of a second player in the market.

Weaknesses of the reform implementation in 2006 include the absence of concrete and realistic targets for R&D, the little progress in improving the co-ordination role and institutional set-up of the new Office for Growth and of the Slovenian Technology Agency and the delays in strengthening the legal framework for protecting Intellectual Property Rights. Strengthening competition rules and enhancing the effectiveness and the resources of the Competition Protection Office have not received sufficient attention. Extensive reforms are necessary towards abolishing anticompetitive rules and practices and introducing more competition in professional services sectors. The weaknesses on the labour market relate mainly to the absence of stronger measures to integrate young people and retain older workers in the labour market, with negative consequences for the sustainability of the pension system. The activation and prevention aspects of employment policy are slow in responding to the fast changing conditions on the labour market. The skills mismatch, faced especially by young highly educated people should be addressed through measures strengthening the link between the education system and the labour market and reducing the segmentation of the labour market.

Based on the Integrated Guidelines for Jobs and Growth, Slovenia was recommended to:

- i) take further steps to strengthen the reform of the pension system and promote active ageing, with a view to increasing the employment rate of older workers and improving long-term sustainability of public finances.
- ii) employment services in relation with flexible contractual arrangements and increased conditionality of benefits, giving high priority to offering services at an earlier stage of unemployment.

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 0 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is

covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the stability programme is partly consistent with the broad economic policy guidelines.

**Table 14: Consistency with the broad economic policy guidelines**

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
<b>1. To secure economic stability</b>				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it <sup>1</sup> .			X	
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .				X
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.				X
<b>2. To safeguard economic and fiscal sustainability</b>				
In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)		X		
<b>3. To promote a growth- and employment-orientated and efficient allocation of resources</b>				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		
<u>Notes:</u> <sup>1</sup> As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. <sup>2</sup> As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”. <sup>3</sup> As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.  <u>Source:</u> Commission services				

\* \* \*

## Annex 1: Glossary

**Automatic stabilisers** Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

**Broad economic policy guidelines (BEPGs)** Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

**Budget balance** The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also known as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government aggregates*. See also *cyclically-adjusted balance*, *primary balance*, *structural balance* and *reference values*.

**Budget constraint** A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

**Budgetary sensitivity** The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance*, *structural balance* and *tax elasticity*.

**Code of conduct** Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

**Contingent liabilities** A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

**Convergence programme** Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme*, *code of conduct* and *medium-term objective*.

**Cyclically-adjusted balance** The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance*, *budgetary sensitivity* and *output gap*.

**Cyclically-adjusted primary balance** The *cyclically-adjusted balance* net of interest expenditure on *general government debt*. See also *interest burden*.

**Debt dynamics** The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

**EDP notification** See *notification of deficit and debt*.

**ERM II** Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of  $\pm 15\%$  are defined.

**ESA95** European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

**Excessive deficit procedure (EDP)** A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

**Fiscal stance** A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

**Funded pension scheme** Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

**Government debt** See *public debt*.

**General government** The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

**Government net lending/borrowing** See *budget balance*.

**Implicit liabilities** Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

**Interest burden** *General government* interest expenditure on *government debt* as a share of GDP.

**Intertemporal budget constraint** A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

**Lisbon strategy** Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

**Long-term sustainability** A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

**Maturity structure of public debt** The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

**Medium-term objective (MTO)** According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

**Minimum benchmark** Estimated budgetary position (in *cyclically-adjusted* terms) that provides a “safety margin” that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

**National reform programme (NRP)** See *Lisbon strategy*.

**Notification of deficit and debt (EDP notification)** Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

**One-off and temporary measures** Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

**Output gap** The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary

pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

**Pay-as-you-go pension scheme (PAYG)** Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

**Primary balance** The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

**Pro-cyclical fiscal policy** A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

**Production function method** A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap*, *cyclically-adjusted balance*, *budgetary sensitivity*.

**Public debt (or government debt)** Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

**Public investment** The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

**Public-private partnerships (PPP)** Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

**Quality of public finances** A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

**Reference values for public deficit and debt** Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure*, *government debt* and *budget balance*.

**Sensitivity analysis** An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

**'Snow-ball' effect** The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

**Stability and Growth Pact (SGP)** Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

**Stability programme** Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme*, *code of conduct* and *medium-term objective*.

**Stock-flow adjustment (SFA)** The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics*.

**Structural balance** The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

**Structural primary balance** The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

**Tax elasticity** A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

## Annex 2: Summary tables from the programme

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

**Table 1a. Macroeconomic prospects**

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	-	4.0	4.7	4.3	4.2	4.1
<b>2. Nominal GDP</b>	B1*g	6620145	5.6	6.6	7.5	6.7	6.3
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	3636387	3.4	3.3	3.6	3.6	3.4
<b>4. Government consumption expenditure</b>	P.3	1295422	2.2	2.8	2.5	2.8	2.5
<b>5. Gross fixed capital formation</b>	P.51	1617250	1.5	8.6	5.5	4.5	4.5
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	-	1.6	1.2	1.1	1.1	1.1
<b>7. Exports of goods and services</b>	P.6	4276117	10.5	9.9	8.3	8.5	8.2
<b>8. Imports of goods and services</b>	P.7	4312210	7.0	9.1	7.7	7.7	7.3
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>		-	2.6	4.5	3.8	3.6	3.4
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	-0.6	-0.4	0.0	0.0	0.0
<b>11. External balance of goods and services</b>	B.11	-	2.0	0.6	0.5	0.6	0.7

**Table 1b. Price developments**

	ESA Code	2005	2005	2006	2007	2008	2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>		-	<b>1.5</b>	<b>1.8</b>	<b>3.1</b>	<b>2.5</b>	<b>2.1</b>
2. Private consumption deflator		-	2.2	2.6	2.6	2.4	2.2
<b>3. HICP</b>		-	2.5	2.7	2.7	2.5	2.2
4. Public consumption deflator		-	3.2	3.0	3.7	3.7	3.7
5. Investment deflator		-	3.7	2.0	2.7	3.0	2.1
<b>6. Export price deflator (goods and services)</b>		-	2.9	4.3	2.6	1.2	1.2
<b>7. Import price deflator (goods and services)</b>		-	5.0	5.2	2.1	1.6	1.6



**Table 1c. Labour market developments**

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons</b> <sup>21</sup>		916.2	0.3	0.9	0.8	0.9	0.7
2. Employment, hours worked <sup>22</sup>							
<b>3. Unemployment rate (%)</b> <sup>23</sup>			6.5	6.4	6.4	6.4	6.3
<b>4. Labour productivity, persons</b> <sup>24</sup>			3.7	3.8	3.5	3.2	3.4
5. Labour productivity, hours worked <sup>25</sup>							
<b>6. Compensation of employees</b>	D.1		5.9	5.9	6.1	6.4	6.2

**Table 1d. Sectoral balances**

% of GDP	ESA Code	2005	2006	2007	2008	2009
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	-1.9				
of which:						
- Balance on goods and services		-0.6	-0.7	0.0	0.2	0.6
- Balance of primary incomes and transfers		-1.4	-1.7	-1.6	-1.5	-1.4
- Capital account		0.1				
2. Net lending/borrowing of the private sector	B.9					
3. Net lending/borrowing of general government	B.9/ EDP B.9	-1.4	-1.6	-1.5	-1.6	-1.0
<b>4. Statistical discrepancy</b>						

<sup>21</sup> Occupied population, domestic concept national accounts definition.

<sup>22</sup> National accounts definition.

<sup>23</sup> Harmonised definition, Eurostat; levels.

<sup>24</sup> Real GDP per person employed.

<sup>25</sup> Real GDP per hour worked.

**Table 2. General government budgetary prospects**

	ESA code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
<b>1. General government</b>	S.13	-9278	-1.4	-1.6	-1.5	-1.6	-1.0
<b>2. Central government</b>	S.1311	-149098	-2.3	-1.5	-1.6	-1.8	-1.1
<b>3. State government</b>	S.1312						
<b>4. Local government</b>	S.1313	3287	0.0	0.0	0.1	0.1	0.0
<b>5. Social security funds</b>	S.1314	53031	0.8	-0.1	0.0	0.1	0.1
<b>General government (S13)</b>							
<b>6. Total revenue</b>	TR	3030061	45.8	45.1	43.6	42.7	41.7
<b>7. Total expenditure</b>	TE <sup>26</sup>	3122841	47.2	46.6	45.1	44.4	42.6
<b>8. Net lending/borrowing</b>	EDP B.9	-9278	-1.4	-1.6	-1.5	-1.6	-1.0
<b>9. Interest expenditure (incl. FISIM)</b>	EDP D.41 incl. FISIM	117238	1.8	1.7	1.4	1.3	1.3
<b>pm: 9a. FISIM</b>							
<b>10. Primary balance</b> <sup>27</sup>		24458	0.4	0.1	-0.1	-0.3	0.3
<b>Selected components of revenue</b>							
<b>11. Total taxes</b> (11=11a+11b+11c)		1695205	25.6	25.1	24.3	23.7	23.1
<b>11a. Taxes on production and imports</b>	D.2	1079906	16.3	15.3	14.8	14.5	13.9
<b>11b. Current taxes on income, wealth, etc</b>	D.5	613387	9.3	9.8	9.5	9.2	9.2
<b>11c. Capital taxes</b>	D.91	1912	0.0	0.0	0.0	0.0	0.0
<b>12. Social contributions</b>	D.61	98062	14.8	14.7	14.4	14.3	14.3
<b>13. Property income</b>	D.4	92778	1.4	1.3	1.3	1.1	1.0
<b>14. Other</b> (14=15-(11+12+13))		261458	3.9	3.9	3.6	3.6	3.3
<b>15=6. Total revenue</b>	TR	3030061	15.8	45.1	43.6	42.7	41.7
<b>p.m.: Tax burden</b> (D.2+D.5+D.61+D.91-D.995) <sup>28</sup>		2675825	40.4	39.8	38.8	38.0	37.4
<b>Selected components of expenditure</b>							
<b>16. Collective consumption</b>	P.32	494445	7.5	7.6	7.5	7.5	7.1
<b>17. Total social transfers</b>	D.62 + D.63						
17a. Social transfers in kind	P.31 = D.63	967436	14.6	14.6	14.4	14.3	13.7
17b. Social transfers other than in kind	D.62	1071513	16.2	16.0	15.5	15.2	15.0
<b>18.=9. Interest expenditure (incl. FISIM)</b>	EDP D.41 incl. FISIM	117238	1.8	1.7	1.4	1.3	1.3
<b>19. Subsidies</b>	D.3	92818	1.4	1.4	1.3	1.5	1.4
<b>20. Gross fixed capital formation</b>	P.51	221547	3.3	3.4	3.2	2.7	2.5
<b>21. Other</b> (21=22-(16+17+18+19+20))		157884	2.4	2.1	1.8	1.8	1.7
<b>22=7. Total expenditure</b>	TE <sup>29</sup>	3122841	47.2	46.6	45.1	44.4	42.6
Pm: compensation of employees	D.1						

<sup>26</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>27</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

<sup>28</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<sup>29</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	2004	2009
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (= item 7=26 in Table 2)	TE <sup>30</sup>		

**Table 4. General government debt developments**

% of GDP		2005	2006	2007	2008	2009
<b>1. Gross debt</b> <sup>31</sup>		28.0	28.5	28.2	28.3	27.7
<b>2. Change in gross debt ratio</b>		-0.7	0.5	-0.2	0.0	-0.5
<b>Contributions to changes in gross debt</b>						
<b>3. Primary balance</b> <sup>32</sup>		-0.4	-0.1	0.1	0.3	-0.3
<b>4. Interest expenditure (incl. FISIM)</b> <sup>33</sup>						
<b>5. Stock-flow adjustment</b>		-0.6	0.6	0.2	0.2	0.2
of which:						
- Differences between cash and accruals <sup>34</sup>						
- Net accumulation of financial assets <sup>35</sup>						
<i>of which:</i>						
- privatisation proceeds						
- Valuation effects and other <sup>36</sup>						
<b>p.m. implicit interest rate on debt</b> <sup>37</sup>		6.5	6.3	5.3	5.0	4.9
<b>Other relevant variables</b>						
6. Liquid financial assets <sup>38</sup>						
7. Net financial debt (7=1-6)						

<sup>30</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>31</sup> As defined in Regulation 3605/93 (not an ESA concept).

<sup>32</sup> Cf. item 10 in Table 2.

<sup>33</sup> Cf. item 9 in Table 2.

<sup>34</sup> The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>35</sup> Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>36</sup> Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>37</sup> Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

<sup>38</sup> AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5. Cyclical developments**

% of GDP	ESA Code	2005	2006	2007	2008	2009
<b>1. Real GDP growth (%)</b>		4.0	4.7	4.3	4.2	4.1
<b>2. Net lending of general government</b>	EDP B.9	-1.4	-1.6	-1.5	-1.6	-1.0
<b>3. Interest expenditure (incl. FISIM recorded as consumption)</b>	EDPD.41 + FISIM	1.8	1.7	1.4	1.3	1.3
4. Potential GDP growth (%) (1)		4.0	4.1	4.3	4.1	4.3
contributions:						
- labour		0.7	0.5	0.4	0.1	0.1
- capital		1.4	1.5	1.6	1.6	1.6
- total factor productivity		1.8	2.1	2.3	2.5	2.6
5. Output gap		-0.4	0.2	0.2	0.3	0.1
6. Cyclical budgetary component		-0.2	0.1	0.1	0.1	0.0
7. Cyclically-adjusted balance (2-6)		-1.2	-1.7	-1.6	-1.8	-1.0
8. Cyclically-adjusted primary balance (7-3)		0.5	0.0	-0.2	-0.4	0.3

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (CP)

**Table 6. Divergence from previous update**

	ESA Code	2005	2006	2007	2008	2009
<b>Real GDP growth (%)</b>						
<b>Previous update</b>		3.9	4.0	4.0	3.8	
<b>Current update</b>		4.0	4.7	4.3	4.2	4.1
<b>Difference</b>		0.1	0.7	0.3	0.4	
<b>General government net lending (% of GDP)</b>	EDP B.9					
<b>Previous update</b>		-1.7	-1.7	-1.4	-1.0	
<b>Current update</b>		-1.4	-1.6	-1.5	-1.6	-1.0
<b>Difference</b>		0.3	0.1	-0.1	-0.6	
<b>General government gross debt (% of GDP)</b>						
<b>Previous update</b>		29.0	29.6	29.8	29.4	
<b>Current update</b>		28.0	28.5	28.2	28.3	27.7
<b>Difference</b>		-1.0	-1.1	-1.6	-0.9	

**Table 7. Long-term sustainability of public finances**

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	-	46.7					
Of which: age-related expenditures	-	18.8	17.5	19.5	22.5	25.8	27.9
Pension expenditure	-	10.9	10.4	11.6	13.6	15.8	17.2
Social security pension	-						
Old-age and early pensions	-						
Other pensions (disability, survivors)	-						
Occupational pensions (if in general government)	-						
Health care	-	6.3	6.2	6.8	7.6	8.4	8.9
Long-term care ( <i>this was earlier included in the health care</i> )	-	0.8	0.9	1.1	1.3	1.6	1.8
Education expenditure	-						
Other age-related expenditures	-						
Interest expenditure	-						
Total revenue	-	44.9					
Of which: property income	-						
<i>of which: from pensions contributions (or social contributions if appropriate)</i>	-	9.9					
Pension reserve fund assets	-						
Of which: consolidated public pension fund assets (assets other than government liabilities)	-						
<b>Assumptions</b>							
Labour productivity growth	-	3.5	3.1	3.0	2.7	1.9	1.7
Real GDP growth	-	4.0	3.7	2.4	2.0	1.0	1.1
Participation rate males (aged 20-64)	-	73.5	76.4	77.9	77.0	75.4	76.4
Participation rates females (aged 20-64)	-	63.9	66.3	69.0	69.8	69.0	70.5
Total participation rates (aged 20-64)	-	68.8	71.5	73.6	73.5	72.3	73.5
Unemployment rate	-	6.0	5.5	5.4	5.4	5.4	5.4
Population aged 65+ over total population	-	15.3	16.5	20.4	25.1	28.4	31.1

**Table 8. Basic assumptions**

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	2005	2006	2007	2008	2009
Short-term interest rate <sup>39</sup> (annual average)					
Long-term interest rate (annual average)					
USD/€ exchange rate (annual average) (euro area and ERM II countries)		1.248	1.265	1.265	
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)		0.2	0.2	0.0	
World excluding EU, GDP growth		5.1	4.9		
EU GDP growth		2.7	2.1	2.1	
Growth of relevant foreign markets		10.3	8.5	8.9	
World import volumes, excluding EU		7.5	6.0	-	
Oil prices, (Brent, USD/barrel)		69.06.9	73.0	73.0	

<sup>39</sup> If necessary, purely technical assumptions.

### Annex 3: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the code of conduct	Yes	No	Comments
<b>1. Submission of the programme</b>			
Programme was submitted not earlier than mid-October and not later than 1 December <sup>1</sup> .		X	Submitted on 7 December 2005.
<b>2. Model structure</b>			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
<b>3. Model tables (so-called data requirements)</b>			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X	
The programme provides all optional information in these tables.		X	Certain optional data missing in Tables 1c, 1d, 4 and 7. Table 3 is not included.
The concepts used are in line with the European system of accounts (ESA).	X		
<b>4. Other information requirements</b>			
<i>a. Involvement of parliament</i>			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
<i>b. Economic outlook</i>			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.	X		However, oil price assumption for 2007-2008, set at 73US\$, is on the high side.
Significant divergences between the national and the Commission services’ economic forecasts are explained <sup>2</sup> .	X		
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	External accounts appear sound.
<i>c. Monetary/exchange rate policy</i>			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
<i>d. Budgetary strategy</i>			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial	X		

<b>Guidelines in the code of conduct</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
deviations, whether measures are taken to rectify the situation, and provide information on them.			
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.		X	
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
<i>e. "Major structural reforms"</i>			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.	X		
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.		X	
<i>f. Sensitivity analysis</i>			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X	X	Not applicable  Not applicable
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.		X	
<i>g. Broad economic policy guidelines</i>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
<i>h. Quality of public finances</i>			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
<i>i. Long-term sustainability</i>			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (...) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
<i>j. Other information (optional)</i>			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
<b>Notes:</b>			
<sup>1</sup> The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.			
<sup>2</sup> To the extent possible, bearing in mind the typically short time period between the publication of the			

Guidelines in the code of conduct	Yes	No	Comments
Commission services' autumn forecast and the submission of the programme.			
<i>Source:</i>			
<i>Commission services</i>			

#### Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

##### Slovenia - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 – 2005			
<b>Economic activity</b>						
Real GDP (% change)	3.9	4.4	3.4	2.7	4.4	4.0
Private consumption (% change)	2.9	3.1	2.6	3.4	2.6	3.4
Government consumption (% change)	3.1	3.4	2.9	1.6	3.4	2.2
Investment (% change)	7.1	10.6	3.5	7.1	7.9	1.5
Exports (% change)	7.5	7.2	7.8	3.1	12.5	10.5
Imports (% change)	7.3	7.6	7.0	6.7	13.4	7.0
Contributions to real GDP growth:						
<i>Domestic demand</i>	3.9	4.8	3.0	4.6	4.9	2.0
<i>Net exports</i>	0.0	-0.4	0.5	-2.0	-0.5	2.0
Output gap (% of potential GDP)	n.a.	n.a.	-1.0	-1.8	-1.3	-1.1
<b>Prices and costs</b>						
HICP inflation (% change)	6.9	8.2	5.6	5.7	3.7	2.5
Unit labour costs (% change)	5.4	5.9	4.9	3.5	3.6	1.6
Labour productivity (% change)	3.9	4.8	3.0	3.1	3.9	3.7
Real unit labour costs (% change)	-1.0	-1.5	-0.5	-2.2	0.3	0.1
Comparative price levels (EUR25=100)	72.9	72.4	73.4	75.3	73.0	73.1
<b>Labour market</b>						
Employment (% change)	0.0	-0.4	0.5	-0.4	0.5	0.3
Employment (% of working age population)	64.4	63.9	64.9	64.8	65.0	65.1
Unemployment rate (% of labour force)	6.7	7.0	6.4	6.7	6.3	6.5
NAIRU (% of labour force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate (% of working age population)	69.1	68.8	69.4	69.4	69.5	69.8
Working age population (% change)	0.2	0.2	0.2	0.2	0.1	0.2
<b>Competitiveness and external position</b>						
Real effective exchange rate (% change) (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	1.5	-0.7	3.7	-1.2	4.4	4.5
External balance of g & s (% of GDP)	-1.2	-2.2	-0.2	-0.1	-1.2	-0.5
External balance (% of GDP)	-1.0	-1.2	-0.8	-0.8	-2.5	-1.9
FDI inflow (% of GDP)	n.a.	n.a.	n.a.	4.2	2.2	1.5
<b>Public finances</b>						
Total expenditure (% of GDP)	n.a.	n.a.	47.9	48.0	47.4	47.2
Total revenue (% of GDP)	n.a.	n.a.	45.3	45.3	45.1	45.8
General government balance (% of GDP)	n.a.	n.a.	-2.7	-2.8	-2.3	-1.4
General government debt (% of GDP)	25.9	23.3	28.5	28.5	28.7	28.0
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-2.0	-1.7	-0.9
<b>Financial indicators (4)</b>						
Short term real interest rate (%) (5)	n.a.	n.a.	1.4	1.0	1.3	2.5
Long term real interest rate (%) (5)	n.a.	n.a.	n.a.	0.6	1.3	2.3
Household debt (% change) (6)	n.a.	n.a.	n.a.	10.8	11.7	22.1
Corporate sector debt (% change) (7)	n.a.	n.a.	n.a.	18.4	14.9	17.6
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	16.6	17.2	20.0
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	50.4	53.8	60.4



**Notes:**

- (1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (= EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.  
 (2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.  
 (3) Cyclically-adjusted budget balance net of one-off and other temporary measures.  
 (4) Data available up to 2004.  
 (5) Using GDP deflator.  
 (6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.  
 (7) Non-financial corporate sector debt, defined as loans and securities other than shares.

**Source:**

*Commission services*

**EUR-12 - Key economic indicators**

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 – 2005			
<b>Economic activity</b>						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption (% change)	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption (% change)	1.7	1.7	1.7	1.8	1.2	1.4
Investment (% change)	2.6	4.3	1.0	1.0	2.2	2.5
Exports (% change)	5.8	8.1	3.5	1.1	6.8	4.3
Imports (% change)	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth:						
<i>Domestic demand</i>	2.0	2.7	1.3	1.4	1.8	1.6
<i>Net exports</i>	0.1	0.1	0.1	-0.7	0.2	-0.2
Output gap (% of potential GDP)	-0.1	-0.1	0.0	-0.6	-0.5	-1.1
<b>Prices and costs</b>						
HICP inflation (% change)	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs (% change)	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity (% change)	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	n.a.	n.a.	102.1	103.0	102.7	102.3
<b>Labour market</b>						
Employment (% change)	1.2	1.5	0.9	0.7	0.7	0.8
Employment (% of working age population)	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate (% of labour force)	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU (% of labour force)	8.7	9.1	8.3	8.4	8.2	8.0
Participation rate (% of working age population)	69.9	68.5	71.2	71.4	71.7	71.8
Working age population (% change)	0.3	0.2	0.4	0.5	0.5	0.5
<b>Competitiveness and external position</b>						
Real effective exchange rate (% change) (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s (% of GDP)	1.9	1.7	2.0	2.1	2.1	1.5
External balance (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (% of GDP)	2.4	2.5	2.2	1.9	1.1	n.a.
<b>Public finances</b>						
Total expenditure (% of GDP)	48.2	48.7	47.7	48.2	47.6	47.6
Total revenue (% of GDP)	45.8	46.5	45.1	45.1	44.8	45.1
General government balance (% of GDP)	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
<b>Financial indicators (4)</b>						
Short term real interest rate (%) (5)	1.7	2.7	0.7	0.2	0.2	0.3
peLong term real interest rate (%) (5)	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% change) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% change) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:

Commission services

## Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)<sup>40</sup>.

Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-

to-GDP ratio of the  $i$ -th tax  $\frac{T_i}{Y}$  can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY} \frac{Y}{T_i} - 1\right) \frac{T_i}{Y} = \left(\frac{dT_i}{dB_i} \frac{B_i}{T_i} \frac{dB_i}{dY} \frac{Y}{B_i} - 1\right) \frac{T_i}{Y} = (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y}$$

where  $\varepsilon_{T_i, B_i}$  and  $\varepsilon_{B_i, Y}$  denote the elasticity of the  $i$ -th tax  $T_i$  relative to its tax base  $B_i$  and the elasticity of the tax base  $B_i$  relative to aggregate GDP  $Y$  respectively.

To the extent that  $\varepsilon_{T_i, B_i}$  is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity<sup>41</sup>. By contrast, if  $\varepsilon_{T_i, B_i}$  is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity  $\varepsilon_{B_i, Y}$  can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the  $i$ -th tax can be written as the product of the semi-elasticity and GDP growth:

<sup>40</sup>Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

<sup>41</sup>The observed or projected elasticity (ex-post elasticity) of the  $i$ -th tax also includes the effect of other factors (OF) such as discretionary measures:  $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex\,ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex\,post} \frac{dB_i}{B_i}$ .

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_i \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[ (\varepsilon_{T_i, B_i}' - \varepsilon_{B_i, Y}') - (\varepsilon_{T_i, B_i} - \varepsilon_{B_i, Y}) \right] \frac{T_i}{Y} \frac{dY}{Y}$$

If  $(\varepsilon_{T_i, B_i}' - \varepsilon_{T_i, B_i}) = \alpha_i$ ;  $(\varepsilon_{B_i, Y}' - \varepsilon_{B_i, Y}) = \beta_i$ ,

$$\text{then } d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[ (\alpha_i \varepsilon_{B_i, Y} + \beta_i \varepsilon_{T_i, B_i} + \alpha_i \beta_i) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

where  $\alpha_i \varepsilon_{B_i, Y} \frac{T_i}{Y} \frac{dY}{Y}$  determines the elasticity component and  $\beta_i \varepsilon_{T_i, B_i} \frac{T_i}{Y} \frac{dY}{Y}$  the composition

component. The third component in the equation  $\alpha_i \beta_i \frac{T_i}{Y} \frac{dY}{Y}$  measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as  $\varepsilon = \sum_i w_i \varepsilon_{T_i, B_i} \varepsilon_{B_i, Y}$

with  $w_i$  the share of the  $i$ -th tax in the overall tax burden.

## Assessment of tax projections by major tax category

	2007			2008			2009
	SP	COM	OECD <sup>1</sup>	SP	COM <sup>2</sup>	OECD <sup>1</sup>	SP
<b>Taxes on production and imports:</b>							
Change in tax-to-GDP ratio	-0.5	-0.4	0.0	-0.3	-0.2	0.0	-0.6
<i>Difference SP – COM</i>	-0.2			-0.2			/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	-0.2			-0.2			/
- composition component	0.1			0.0			/
<i>Difference COM – OECD<sup>1</sup></i>	/	-0.4		/	-0.2		/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	/	-0.1		/	0.0		/
- composition component	/	-0.3		/	-0.1		/
p.m.: Elasticity							
- of taxes to tax base <sup>4</sup>	0.6	0.9	1.0	0.8	1.0	1.0	0.3
- of tax base <sup>4</sup> to GDP	0.8	0.8	1.0	0.9	0.9	1.0	0.9
<b>Social contributions:</b>							
Change in tax-to-GDP ratio	-0.3	-0.4	-0.3	-0.1	-0.3	-0.3	0.0
<i>Difference SP – COM</i>	0.0		/	0.2		/	/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	0.0		/	0.1		/	/
- composition component	0.0		/	0.0		/	/
<i>Difference COM – OECD<sup>1</sup></i>	/	0.0		/	0.0		/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	/	-0.1		/	-0.1		/
- composition component	/	0.1		/	0.2		/
p.m.: Elasticity							
- of taxes to tax base <sup>5</sup>	0.9	0.8	1.0	0.9	0.8	1.0	1.0
- of tax base <sup>5</sup> to GDP	0.8	0.8	0.7	1.0	0.9	0.7	1.0
<b>Personal income tax<sup>6</sup>:</b>							
Change in tax-to-GDP ratio	-0.3	0.0	0.2	-0.3	0.0	0.2	0.0
<i>Difference SP – COM</i>	-0.3		/	-0.3		/	/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	-0.3		/	-0.3		/	/
- composition component	0.0		/	0.0		/	/
<i>Difference COM – OECD<sup>1</sup></i>	/	-0.2		/	-0.2		/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	/	-0.3		/	-0.3		/
- composition component	/	0.1		/	0.2		/
p.m.: Elasticity							
- of taxes to tax base <sup>5</sup>	0.7	1.3	1.9	0.5	1.2	1.9	1.0
- of tax base <sup>5</sup> to GDP	0.8	0.8	0.7	1.0	0.9	0.7	1.0
<b>Corporate income tax<sup>6</sup>:</b>							
Change in tax-to-GDP ratio	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0
<i>Difference SP – COM</i>	-0.1		/	-0.1		/	/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	-0.1		/	-0.1		/	/
- composition component	0.0		/	0.0		/	/
<i>Difference COM – OECD<sup>1</sup></i>	/	-0.1		/	0.0		/
<i>of which</i> <sup>3</sup> :							
- discretionary & elasticity component	/	0.0		/	0.0		/
- composition component	/	0.0		/	0.0		/
p.m.: Elasticity							
-of taxes to tax base <sup>7</sup>	0.5	0.9	1.0	0.5	0.9	1.0	1.0
-of tax base <sup>7</sup> to GDP	1.2	1.2	1.5	1.0	1.1	1.5	1.0
<b>Notes:</b>							
<sup>1</sup> Based on OECD ex-ante elasticities							
<sup>2</sup> On a no-policy change basis							
<sup>3</sup> The decomposition is explained in the text above							
<sup>4</sup> Tax base = private consumption expenditure							
<sup>5</sup> Tax base = compensation of employees							
<sup>6</sup> Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period							
<sup>7</sup> Tax base = gross operating surplus							
<b>Source:</b>							
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							