COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 23.1.2007
SEC(2007) 69 final

Recommendation for a

COUNCIL OPINION

in accordance with the first paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the stability programme of Slovenia, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. General background

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

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

2. Background for the assessment of the new programme

The Commission has examined the first stability programme of Slovenia[2] submitted on 7 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points of the assessment).

In order to set the scene against which the budgetary strategy in the stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the last update of the convergence programme) and

(3) the Commission's assessment of the October 2006 national reform programme.

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Article 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, when the first EU Member States adopted the single currency] shall submit a stability programme within six months of the Council decision on its participation in the single currency". On 11 July 2006, the Council adopted a decision on introduction of the single currency in Slovenia as of 1 January 2007, in accordance with Article 122(2) of the Treaty (Council Decision 2006/495/EC, OJ L 195, 15.7.2006, p. 25).

2.1. Recent economic and budgetary performance

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.

2.2. The assessment in the Council opinion on the previous programme

On 14 February 2006, the Council adopted its opinion on the last update of the convergence programme, covering the period 2005-2008. The Council was of the opinion that "the programme aims at containing inflation close to the EU average while projecting a gradual fiscal adjustment path". The Council invited Slovenia to "make a more rapid progress towards achieving the programme's MTO, especially by implementing the measures underlying the planned reduction of the expenditure ratio as well as by frontloading the adjustment effort" and to "undertake measures to improve the long-term sustainability of the public finances, particularly in relation to the pension system".

2.3. The Commission assessment of the October 2006 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. 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 (adopted as part of its December 2006 annual Progress Report[3]) showed that Slovenia is making good progress in implementing its National Reform Programme. 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.

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.

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[3] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

Box: Main points of the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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4 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

5 "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.

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On the stability programme of Slovenia, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 5(1) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the first stability programme of Slovenia, which covers the period 2006 to 2009.

(2) The macroeconomic scenario underlying the 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.

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

(4) 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

[6] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

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.

(5) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve by around ¼% of GDP. 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. Since the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), reaching it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential growth in the long term.

(6) 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.

(7) 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, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times. 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.

(8) Government gross debt is estimated to have reached 28.5% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 0.8 percentage point over the programme period.

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

(10) The stability programme contains a qualitative assessment of the overall impact of Slovenia's October 2006 national reform programme within the medium-term fiscal strategy. In addition, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme but its budgetary projections do not explicitly take into account the public finance implications of all actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. 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.

(11) The budgetary strategy in the programme is partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the adjustment path towards the MTO is insufficient and should be strengthened.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[7].

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. In view of the above assessment, Slovenia is invited to:

(i) use the good economic conditions to hasten the achievement of the MTO by frontloading the adjustment effort; and

(ii) in view of the projected increase in age related expenditure, improve the long-term sustainability of public finances by strengthening the ongoing pension reform with additional measures, geared especially to increasing labour participation of older workers and encouraging the development of private pension saving schemes.

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[7] In particular, net external balances for 2006-2007 as well as certain optional data concerning sectoral balances, labour market developments, general government expenditure by function and debt evolution are not provided.

Comparison of key macro economic and budgetary projections

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

Notes:

[1] Commission services calculations on the basis of the information in the programme.

[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

[3] There are no one-off or other temporary measures in the programme.

[4] There are no one-off or other temporary measures in the Commission services' autumn 2006 forecast.

[5] Based on estimated potential growth of 3.8% in 2005 and 4% in 2006-2008.

Source:

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