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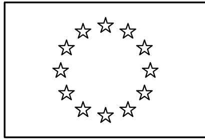

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2009
SEC(2009) 866 final

Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Slovenia, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact 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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to the definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

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 each Member State has to submit, to the Council and the Commission, a stability or convergence programme 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Slovenia, submitted on 23 April 2009, and has adopted a recommendation for a Council opinion on it.[2]

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

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan"); and

(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 previous update of the stability programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[3]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] The Stability and Growth Pact requires the Commission to prepare a report under Article 104(3) of the Treaty when an actual or planned deficit exceeds the 3% of GDP reference value. In view of the great uncertainty surrounding the current economic juncture, the Commission considers it appropriate that reports based on planned deficits for 2009 in excess of the reference value take account of further information.

[3] Communication from the Commission to the European Council - COM(2008) 800, 26.11.2008.

priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. While it is still relatively early to assess the impact of these measures, the opinions on stability and convergence programmes include a preliminary evaluation of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2010, as follows. “The overall conclusion is that Slovenia met its MTO in 2007, two years ahead of previous plans, and that the programme aims at respecting the MTO by a growing margin over the programme period. For 2007, the most recent available information points to a better-than-planned budgetary outturn, possibly a slight surplus. However, for 2008, a slight deterioration of the structural balance is envisaged despite the continuing strong growth prospects. The risks to the budgetary projections are broadly balanced in 2008. In the outer years, budgetary outcomes might be slightly worse than targeted, mainly due to risks associated with the envisaged reliance on expenditure restraint. The fiscal stance in 2008 may turn out to be pro-cyclical. A tighter fiscal stance than presently envisaged for 2008 appears to be warranted also given the current strong inflationary pressures. The high projected increase in public sector wage settlements is also a concern for the inflation outlook. In spite of the current low debt level, Slovenia is assessed to be at high risk with regard to the long-term sustainability of public finances due to the significant projected budgetary impact of ageing.” The Council invited Slovenia to “building on a likely better-than-expected outturn in 2007, aim for stronger budgetary positions in 2008 and beyond than planned in the programme, thereby avoiding pro-cyclical policies”, “stand ready to adopt further measures to tame inflationary pressures, complementing the recommended fiscal stance with appropriate wage, labour market and competition policies, and “in view of the projected increase in age-related expenditure, improve the long-term sustainability of public finances, in particular by further reforming the pension system”.

Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Slovenia, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[4], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [7 July 2009] the Council examined the updated stability programme of Slovenia, which covers the period 2008 to 2011.

(2) Slovenia's solid economic growth in recent years, averaging 5% in 2004-2008, has been marked by a strong performance of exports and investments. Given its very high degree of openness, the economy has been severely hit by the global crisis. Activity decelerated markedly throughout 2008, with a steep fall in the final quarter. The effect of the global crisis came on top of rising unit labour costs affecting exports and weakening confidence, in turn limiting investment. In addition, while supported by a strong increase in employment and wages, private consumption was held back by high inflation and falling consumer confidence. Using the room for fiscal manoeuvre offered by the moderate deficit and debt levels going into the crisis, the authorities have adopted measures to support the economy, aimed at stabilising the financial system, safeguarding jobs and enhancing growth potential, while firms also benefit from tax relief decided before the onset of the crisis. At the same time, given the necessity to improve the long-term sustainability of public finances, consolidation measures have been taken and further savings have been adopted after the programme submission (in the supplementary budget that was adopted by the government on 17 June) to stem the rapid rise in the government deficit, from below 1% of GDP in 2008 to more than 5% of GDP in 2009 (about half of the deterioration reflects the working of automatic stabilisers). The removal of fiscal stimulus and the return to budgetary consolidation are a key challenge going forward, together with the need to improve long-term sustainability through a reform of the pension system. Another challenge is

[4] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

to improve competitiveness through adequate wage policies and efforts in the area of research and innovation that should help increase the technological intensity of manufacturing.

(3) The macroeconomic scenario underlying the programme envisages that, after expanding by 3.5% in 2008, real GDP will fall by 4% in 2009 before recovering to positive and increasing growth over the rest of the programme period. Assessed against currently available information[5], notably real GDP data for the first quarter of 2009 that was released after the programme submission, this scenario appears to be based on favourable growth assumptions. Economic growth in 2009 could be lower than projected in the programme and the recovery could be more muted in 2010. Also in the light of this, the rise in unemployment could be somewhat faster than foreseen in the update. By contrast, the programme's projections for inflation, which is forecast to moderate significantly from its 2008 peak, appear realistic. The update projects a more pronounced narrowing of the external deficit than the Commission services in 2009 (from 5.6% of GDP in 2008) against the background of a significant downward adjustment in private sector wage growth.

(4) The outturn for the 2008 general government deficit is estimated at 0.9% of GDP, in line with the target set in the previous update of the stability programme, but against a lower GDP growth than envisaged (outturn at 3.5 % against 4.6 % planned). Budgetary execution was marked by sizeable expenditure overruns. These have prevented over-achieving the target for 2008, which would have been possible in view of (i) the 2007 outcome being more than 1 percentage point of GDP better than expected in the previous programme and (ii) stronger revenue growth in 2008 than budgeted. Revenue rose 7.1% instead of 6.4% as planned, with positive developments in personal income tax, social contributions and non-tax revenues. Expenditure increased by 10.7% instead of 7.4%, with overruns in public investment, social transfers and compensation of employees.

(5) According to the updated programme, the general government deficit is targeted to widen significantly in 2009, to 5.1% of GDP, reflecting the working of the automatic stabilisers and various discretionary measures as well as the strong dynamics of social transfers (especially from indexation arrangements) and compensation of employees (owing to the agreement to address "wage disparities"). According to the programme, measures to support the economy, laid down in the government's stimulus packages as well as expansionary measures taken before the onset of the crisis (mainly tax relief for companies), would add up to almost 2% of GDP. At the same time, consolidation measures have been adopted in the form of a rise in excise duties and expenditure savings on the public sector wage bill, intermediate consumption and investment. The latter were announced in the stability programme and later only partly confirmed in the supplementary budget. The programme envisages a widening of the structural deficit, i.e. the cyclically-adjusted deficit net of one-off and other temporary measures, by 1¼ percentage points of GDP (calculated according to the commonly agreed methodology), which points to an expansionary fiscal stance.

(6) The programme's medium-term strategy is to reduce the general government deficit over the programme period through a frontloaded adjustment, from just over 5% of GDP in 2009 to 3.4% of GDP in 2011. The primary deficit would improve slightly

[5] The assessment notably takes into account the Commission services' spring 2009 forecast, but also other information that has become available since then.

faster given a projected rise in the interest burden. The programme confirms the medium-term objective (MTO) for the budgetary position of Slovenia to be a structural deficit of 1% of GDP but, while envisaging progress towards the MTO from 2010 onwards, it does not foresee the MTO to be reached within the programme period. Reflecting the aim of "withdrawing the fiscal stimulus in line with economic recovery by 2011", the envisaged consolidation falls predominantly on the expenditure side, driven by a decline in subsidies by 1 percentage point of GDP between 2009 and 2011. The wage subsidy scheme should be phased out in 2010 and the remaining stimulus measures on the expenditure side in 2011. The projected rise in the interest burden by ¼ of a percentage point of GDP over the programme period is broadly offset by a decline in compensation of employees as a share of GDP. The envelope for social transfers is planned to be frozen until the end of 2010 (at the level reached in the first half of 2009). Revenue is envisaged to rise by ½ percentage point of GDP in 2010. The government gross debt ratio, estimated at 22.8% of GDP in 2008, is projected to increase by 13.5 percentage points over the programme period. The sizeable increase in the primary deficit accounts for more than half of the rise in the debt ratio but the snow-ball effect and a significant stock-flow adjustment in 2009 reflecting recapitalisations and liquidity operations to support the financial sector also contribute.

(7) The budgetary outcomes in the programme are subject to downside risks throughout the programme period. First, economic growth could be lower than projected in the programme. Second, as suggested by the supplementary budget adopted after the programme submission, the expenditure savings announced in the stability programme for 2009 on intermediate consumption and investment may not be realised fully. There are also risks of expenditure overruns: for example, the envisaged further restraint in the wage bill still has to be negotiated with the social partners. Also, it might be difficult to ensure the planned reversal of the stimulus measures on the expenditure side, which consist mainly of subsidies. Third, on top of the impact of possibly lower economic growth, revenue shortfalls may materialise from 2010 onwards, given that the projected rise in indirect taxes as a share of GDP in 2010 is not substantiated in the programme. Finally, the sizeable government guarantees provided as part of the measures to support the financial sector constitute a further risk to the budgetary targets (expenditure would increase if and when guarantees are called). The negative risks to the budgetary targets compounded by uncertainty about the stock-flow adjustment imply that the debt ratio could rise faster than projected in the programme.

(8) The long-term budgetary impact of ageing in Slovenia is well above the EU average, mainly as a result of a relatively high projected increase in pension expenditure as a share of GDP over the coming decades. The budgetary position in 2008 estimated in the programme, which is worse than the starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. Reducing the primary deficit over the medium term, as foreseen in the programme, and a further pension reform aimed at curbing the substantial increase in age-related expenditures, in particular by encouraging longer working lives, would contribute to reducing the high risks to the long-term sustainability of public finances.

(9) The Slovenian budgetary framework offers scope for improvement, especially in the area of spending control in view of the reliance of the consolidation strategy on expenditure restraint. At the same time, public spending efficiency, including in the area of health care, could be enhanced so as to help ensure that expenditure restraint does not compromise the level of services provided. To achieve this goal, the

government intends to introduce performance-based budgeting as of the next budgetary cycle (2010-2011) but the programme does not provide details on how this will be done in practice.

(10) Slovenia adopted several measures to safeguard the stability of the financial sector. In autumn 2008 an unlimited government guarantee on bank deposits of individuals was introduced. In addition, the government is entitled to utilise the following types of measures: (i) loans to, and equity investments in, credit institutions, (re-)insurance companies and pension companies; (ii) government guarantees to credit institutions for refinancing operations; and (iii) purchases of claims from credit institutions. These measures are planned to be phased out by the end of 2010. The ceiling on the overall volume of government guarantees has been set at EUR 12 billion (33% of GDP). A second set of measures, adopted in early 2009, consists of a government guarantee scheme for bank loans to enterprises and the recapitalisation of the Slovene Export and Development Bank and of the Fund for Entrepreneurship (together amounting to 0.6% of GDP). Finally, the government has temporarily deposited the proceeds of some recent bond issuances with banks.

(11) In line with the European Economic Recovery Plan agreed in December 2008 by the European Council, Slovenia adopted two stimulus packages. Together with tax relief benefitting companies decided before the onset of the crisis, the stimulus measures would add up to almost 2% of GDP and would be partly financed by the already adopted and announced consolidation measures. They appear to be an adequate response to the economic downturn given that the room for fiscal manoeuvre offered by the moderate deficit and debt levels going into the crisis is constrained by the long-term sustainability challenges. The stimulus measures can be regarded as timely and targeted as they focus on stemming the deterioration in the labour market and enhancing growth potential and competitiveness by stimulating investment in new technologies and R&D. A third set of measures, re-allocating part of the funds from the previous two packages in light of the low take-up of the wage subsidy scheme, was adopted by the government after the programme submission. It envisages further support to the labour market and a lump-sum transfer to disadvantaged individuals. The expenditure-related stimulus measures (mainly subsidies) are intended to be temporary – valid for one or two years – but the remaining measures, including the tax relief decided earlier, are of a permanent nature. Ongoing infrastructural investment should provide further support to the recovery. The measures adopted by the authorities are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs and endorsed by the Spring European Council on 19 March.

(12) After the strong increase in 2009 the deficit is projected to narrow gradually, especially in 2010. Taking into account the risks to the budgetary targets, the deficit will not be brought back below the 3% of GDP reference value by the end of the programme period (2011). The 2009 deficit is likely to widen substantially, possibly beyond the programme target. The budgetary stance in the programme in 2010 and 2011 would not ensure an adequate structural improvement in view of the long-term sustainability challenge, unless the above-mentioned risks to the budgetary targets are addressed, in particular by reversing the stimulus as the recovery takes hold, implementing further consolidation measures and ensuring tight control over expenditure. Furthermore, the envisaged adjustment in 2011 should be speeded up in view of the projected strengthening of economic growth.

(13) 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[6].

The overall conclusion is that fiscal policy in Slovenia will be expansionary in 2009 in line with the European Economic Recovery Plan (EERP). Slovenia adopted measures to support the economy in line with the room for manoeuvre offered by moderate deficit and debt levels going into the crisis, which together with tax relief benefiting companies decided before the onset of the crisis, appear to be an adequate response to the EERP. They are timely, targeted and partly temporary. In addition to supporting the economy and employment, they aim at enhancing growth potential and competitiveness by stimulating investment in new technologies and R&D. At the same time, as the room for fiscal manoeuvre is constrained by the long-term sustainability challenge, consolidation measures to help finance the stimulus measures have been adopted. The programme announces additional savings for 2009 that appear to have been only partly confirmed in the supplementary budget adopted on 17 June. Thereafter, the programme plans a return to fiscal consolidation, with improvements in the primary structural balance in 2010 and, to a lesser extent, 2011, but the deficit is not foreseen to be brought below the 3% of GDP reference value by the end of the programme period. The budgetary strategy is subject to downside risks, as economic growth could be lower than projected. In addition, it might be difficult to reverse the stimulus measures and expenditure overruns cannot be excluded. Although the debt ratio is low (albeit increasing rapidly), Slovenia is assessed to be at high risk with regard to the long-term sustainability of public finances due to the significant projected budgetary impact of ageing.

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

(i) implement the stimulus measures in 2009 in line with the EERP;

(ii) start reversing the fiscal stimulus as planned in the programme in 2010 and strengthen the adjustment foreseen for 2011 in the light of the assumed pick-up in economic growth; in so doing, keep tight control over government expenditure;

(iii) in view of the projected increase in age-related expenditure, improve the long-term sustainability of public finances by further reforming the pension system, in particular with a view to encouraging longer working lives.

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[6] In particular, data on net lending/borrowing vis-à-vis the rest of the world are not provided.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	**SP Apr 2009**	**6.8**	**3.5**	**-4.0**	**1.0**	**2.7**
	COM Spring 2009	6.8	3.5	-3.4	0.7	n.a.
	SP Nov 2007	*5.8*	*4.6*	*4.1*	*4.5*	*n.a.*
HICP inflation[4] (%)	**SP Apr 2009**	**3.6**	**5.7.**	**0.4**	**1.6.**	**2.6.**
	COM Spring 2009	3.8	5.5	0.7	2.0	n.a.
	SP Nov 2007	*3.4*	*3.5*	*2.8*	*2.6*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Apr 2009**	**4.7**	**4.4**	**-2.3**	**-3.5**	**-3.1**
	COM Spring 2009	4.5	3.2	-1.3	-2.7	n.a.
	SP Nov 2007	*0.7*	*0.5*	*0.1*	*0.2*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Apr 2009**	***n.a.***	***n.a.***	***n.a.***	***n.a.***	***n.a.***
	COM Spring 2009	-3.7	-5.6	-4.6	-4.4	n.a.
	SP Nov 2007	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Apr 2009**	**0.5**	**-0.9**	**-5.1**	**-3.9**	**-3.4**
	COM Spring 2009	0.5	-0.9	-5.5	-6.5	n.a.
	SP Nov 2007	*-0.6*	*-0.9*	*-0.6*	*0.0*	*n.a.*
Primary balance (% of GDP)	**SP Apr 2009**	**1.8**	**0.2**	**-3.6**	**-2.2**	**-1.6**
	COM Spring 2009	1.8	0.2	-3.9	-4.7	n.a.
	SP Nov 2007	*0.7*	*0.2*	*0.6*	*1.1*	*n.a.*
Cyclically-adjusted balance[2] (% of GDP)	**SP Apr 2009**	**-1.6**	**-2.9**	**-4.1**	**-2.3**	**-2.0**
	COM Spring 2009	-1.7	-2.5	-4.9	-5.2	n.a.
	SP Nov 2007	*-0.9*	*-1.1*	*-0.7*	*-0.1*	*n.a.*
Structural balance[3] (% of GDP)	**SP Apr 2009**	**-1.6**	**-2.9**	**-4.1**	**-2.3**	**-2.0**
	COM Spring 2009	-1.7	-2.5	-4.9	-5.2	n.a.
	SP Nov 2007	*-0.8*	*-1.0*	*-0.7*	*-0.1*	*n.a.*
Government gross debt (% of GDP)	**SP Apr 2009**	**23.4**	**22.8**	**30.5**	**34.1**	**36.3**
	COM Spring 2009	23.4	22.8	29.3	34.9	n.a.
	SP Nov 2007	*25.6*	*24.7*	*23.8*	*22.5*	*n.a.*

Notes:
[1] Output gaps and cyclically-adjusted balances according to the programme as recalculated by Commission services on the basis of the information in the programme.
[2] Based on estimated potential growth of 3.9%, 4.9%, 1.0% and 2.2% respectively in the period 2007-2010.
[3] One-off and other temporary measures are zero according to the most recent programme and the Commission services' spring 2009 forecast.
[4] For the programmes the CPI definition is shown.

Source:

Stability programmes (SP); Commission services' spring 2009 forecasts (COM); Commission services' calculations