COUNCIL OF THE EUROPEAN UNION

Brussels, 11 May 2009

9677/09

UEM 151

COVER NOTE

from:	Mr Igor SENČAR, Permanent Representative of Slovenia to the European Union
date of receipt:	30 April 2009
to:	Mr Javier SOLANA, Secretary-General/High Representative
Subject:	Update of Stability Programme of Slovenia - 2008

In accordance with Council Regulation (EC) N° 1466/97, I am pleased to enclose the update of the Stability Programme of Slovenia which the Government hast just approved.

(Complimentary close)

(s.) Igor SENČAR

Encl.:

THE REPUBLIC OF SLOVENIA

STABILITY PROGRAMME

2008 Update

Ljubljana, April 2009

CONTENTS

FOREWORD

This is the first Stability Programme of the new government of Slovenia that took office on 21 November 2008 amid strong deterioration of international environment resulting from the international financial crisis and which has fast translated to the real sector. The main task of the government has been addressing the impact of the crisis to the Slovenian economy. The document includes the government policy response to date and the policy orientation ahead to mitigate the impact of the crisis and contribute to recovery. The policy is set in a framework aiming at ensuring macroeconomic stability and reestablishing fiscal consolidation in line with economic recovery. The document has been prepared in accordance with Council Regulation (EC) No. 1055/2005 amending Regulation 1466/97, which sets out the rules covering the content of Stability Programmes. The update of the Stability program conforms to the revised Opinion on the content and format of Stability and Convergence Programmes agreed by the Economic and Financial Committee of the EU in September 2005 and October 2007.

In conformity with the guidelines of the revised Stability and Growth Pact, that enhance national ownership, the Stability Program and its updates are discussed in the working bodies of the Parliament of the Republic of Slovenia. These bodies also consider the draft opinion of the Council on the Stability Program of the Republic of Slovenia.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

As a result of the financial crisis and recession in major trading partners Slovenia is currently facing the most important challenge in post transition history as an independent State. The crisis has been transmitted to the economy through the dysfunction of the European financial market, in particular of the interbank market, and as a result of the external demand shock. Slovenia is a very open economy with an export share in GDP of about 70%. The drastic contraction in export demand is estimated in a reduction of real export growth of close to 9 percent in 2009. The nominal reduction in exports and as result of the international environment on investments as a share in GDP is estimated in 10 and 5.5 percent respectively in 2009.

The dimension of the shock poses a formidable challenge to the economy and to fiscal policy as a tool for policy response. This is due to the magnitude of the shock and because it is difficult to offset by expansionary fiscal policy in a small and open economy. In addition, fiscal policy has to cope with loss of revenue arising not only from the effect of the crisis but also from changes in the tax structure in favor to more elastic tax components which are exposed by the crisis. In particular, there were important changes in the tax structure over the past years which were financed partly with adopted budget outlays planned with lower GDP growth estimates than actual realization and partly with tax buoyancy resulting from strong economic performance. As a result, under the new economic conditions the challenge is simultaneously offsetting the impact of the crisis and financing existing obligations. The government response to this challenge is within a framework that aim at limiting the crowding effect of increase of interest payments on existing obligations and ensure consistency with public finance stability over the medium and long term. Such an approach is followed taking into account the uncertainty surrounding the duration of the crisis and the risk imposed to fiscal developments arising from a weak economic recovery in Europe.

Within the EU agreed policy response framework to the crisis the government is implementing policy measures aiming at supporting the financial system in maintaining credit flow to the economy, offsetting the impact of the crisis in the real sector and maintaining existing safety net for the population[1]. The fiscal response package was decided upon taking into account the characteristics of the Slovenian economy in particular its size and openness and prioritizing targeted and temporal measures. The policy focus has been to limit the negative impact of external demand shock on existing production capacity and jobs[2]. In particular, the key policy, in terms of budget allocation, which is of temporary nature, aims at preserving employment. It has been built on previously adopted tax measures reducing tax wedge and tax burden on enterprises but implemented in 2009. The focus on employment is

[1] Policy measures are in conformity with relevant decisions adopted by the European Council concerning the financial sector on the 15 and 16 October and on budgetary stimulus measures adopted on the 11 and 12 December 2008

[2] For measure adopted as of december 2008 see addendum

particularly important taking into account the important progress made in creation of jobs over the past years and its positive impact in public finances. The other important policy pillar is the speeding up and maximizing withdrawal from the EU funds aimed at investment. Nevertheless, in order to finance policies supporting the banking sector credit provision and the economy the government has taken measure on the revenue and expenditure side to contain further deterioration of the fiscal stance. However, given the strong economic deterioration as imbedded in the economic forecast for this year further policy measures to those already included in the 2009 supplementary budget will be taken during this year. The measures will ensure consistency between the objectives of mitigating the impact of the crisis, maintaining existing safety net and ensuring fiscal consolidation in line with the envisage pace of economic recovery. Such a policy approach is built in the fiscal policy aggregates presented in this Stability Programme.

During past years important progress has been made on structural reform resulting in creation of jobs, enhancing education structure of the population, improving the business environment and knowledge base economy[3]. Preserving the benefits achieved depends very much today on maintaining the flow of credit to the economy particularly to SMEs and preserving and enhancing productive capacity. This approach has been followed by the measures adopted so far by the government. Other important reform measures envisaged by the new government include reducing administrative burden; enhancing regulatory structure; improving business environment and quality of education and; strengthening the link between research and business activity.

The government has set a working group on modernization of the pension system with the aim to propose additional measures to those that are being currently implanted with the 1999 pension reform. Additional reform measures should enhance long-term sustainability of public finances. The same hold true for the reform of the healthcare system, the system of long-term care and the system of social transfers. The respective working groups will finalize their proposals by autumn with a view of adopting them by the end of the year.

2. ECONOMIC TRENDS AND FORECASTS OF MACROECONOMIC AGGREGATES[4]

2.1. Assumptions for the international environment

The Spring Forecast of Economic Trends 2009 (IMAD, April 2009), which is the basis for macroeconomic forecasts in the Stability Program, takes into account as the international environment assumption the forecasts of international institutions

[3] Slovenia: Implementation report on the National Reform Programme.
[4] The macroeconomic aggregates are forecasted based on no-policy-change concerning fiscak policy. Adjustments to the fiscal policy set forth herein are likely to impact considerably a number of macroeconomic aggregates, most notably government consumption and the wages in the public sector.

published by the end of March 2009 (see Table 2.1). Assumptions for 2009 anticipate recession in most of Slovenia's main trading partners. The key reason for considerably lower expectations this year remains the financial crisis, which spilled over to other sectors of the economy through tightened lending conditions and more expensive loans coupled with a steep business confidence decline. The latest projections suggest that recession tendencies might ease towards the end of this year. A gradual recovery of economic growth in the euro area countries can only be expected in the second half of 2010, though individual countries are still forecast to post GDP declines in the year as a whole. A recovery of economic growth in the euro area is expected in 2011, when economic growth should remain slightly below the long-term average. In most of Slovenia's trading partners from South-Eastern and Eastern Europe a real GDP decline is expected in 2009, while a gradual recovery is predicted for 2010, picking up slightly in 2011.

Table 2.1: Assumptions of the Spring Forecast of Economic Trends 2009 (IMAD) regarding economic growth in Slovenia's main trading partners in 2009–2011

	2007	2008	2009	2010	2011
			Spring forecast (March 2009)	Spring forecast (March 2009)	Spring forecast (March 2009)
EU	2.9	0.9	-3.9	-0.3	1.9
Euro area	2.7	0.8	-4.1	-0.3	1.8
Germany	2.5	1.3	-5.1	0.1	1.6
Italy	1.5	-1.0	-4.2	-0.4	1.2
Austria	3.1	1.8	-3.5	-0.3	1.8
France	2.2	0.7	-3.3	0.0	1.7
United Kingdom	3.1	0.7	-3.5	-0.2	2.1
Czech Republic	6.5	3.5	-1.8	1.7	3.8
Hungary	1.3	0.5	-4.0	0.7	3.0
Poland	6.5	5.4	0.2	2.3	3.8
Croatia	5.6	2.2	-3.0	1.0	4.0
Bosnia and Herzegovina	6.0	5.6	-2.0	-1.0	0.0
Serbia	7.5	5.6	-3.0	0.0	2.0
Macedonia	5.1	4.6	-2.0	0.0	2.0
USA	2.0	1.1	-4.0	0.0	3.3
Russia	8.1	5.6	-4.0	2.5	4.6

Source: Eurostat; Consensus Forecasts, January 2009, February 2009, March 2009; ECB staff macroeconomic projections for the euro area, March 2009; Economist Intelligence Unit Country Reports (for Bosnia, Serbia and Croatia), January 2009, February 2009; WIIW Current Analysis and Forecasts, February 2009; own estimate.

The Spring Forecast of Economic Trends 2009 is based on international environment assumptions of March 2009, while common European Commission assumption for the preparation of stability programs and convergence programs, which were harmonized within the EFC, are based on the autumn forecast of the European Commission, which was published in November 2008. Since during that time the economic situation and the prospects in the international economic environment deteriorated significantly due to the deepening of the international financial and economic crisis, the large difference between the international environment

assumptions in the Stability Program and the Common Assumptions is understandable (in these conditions the use of Common Assumptions would be unrealistic for preparing forecasts).

Table 2.2: Assumptions for the international environment

	2008	2009	2010	2011
USD/EUR exchange rate (annual average) (Euro area and ERM II countries)[1]	1,471	1,275	1,269	1,269
Nominal effective exchange rate[2]	0,5	-0,1	0,0	0,0
GDP growth in the EU	0,9	-3,9	-0,3	1,9
Growth of relevant export markets[3]	1,0	-10,2	1,0	4,9
Oil prices (Brent, USD/barrel)	96,9	45,0	55,0	60,0

Source: IMAD, Spring Forecast 2009. Notes:
[1] Technical assumption based on trends in the period from 9 February to 6 March 2009.
[2] Germany, France, Italy, Austria, Hungary, Poland, Czech Republic, Slovakia, United Kingdom, Switzerland, USA, Japan.

2.2. Cyclical trends and short-term prospects

GDP is expected to fall in real terms in 2009 (-4.0%) for the first time since 1992, as a result of increasingly negative impacts of the international financial and economic crisis. Owing to a rapid decline in exports and investment, economic activity in Slovenia dropped already in the last quarter of 2008, for the first time in the last 16 years (GDP fell in real terms by 0.8% year on year and by 4.1% compared to previous quarter). Amid deteriorating economic conditions in the international environment and shrinking foreign demand, negative export trends deepened somewhat further in the first months of this year. Increased uncertainty and financial restraints contributed also to a decline in construction activity. In view of ever stronger impacts of the financial crisis on real flows of goods and services worldwide, the forecasts of international institutions have been deteriorating already since last September when the global economic crisis started to deepen.

A strong decline in foreign demand and limited sources of finance are the key reason for the downward revision of exports (-8.6%) and fixed capital formation (-12%), which were the key factors of economic growth in the previous years. As regards exports, mostly due to the drop in foreign demand the export of goods will drop more (-10.2%) that the export of services (-2.1%). Given Slovenia's high dependency on exports, the conditions in the international economic environment have a relatively greater impact on investment decisions of enterprises regarding machinery and equipment purchases; therefore, a strong decline in private investment is expected. In addition, after high levels in the past years and problems with financing, this year it is not expected that infrastructural investment will increase, except investment in the energy sector. Construction of residential and non-residential buildings is also expected decline. The slowdown of export and investment activity will be gradually followed by consumption of the population, which will according to expectations this year fall below last year's level (-0.6%). In addition to the worse labour market situation and related modest increase in disposable income, private consumption will feel the negative impact of worse consumers' expectations regarding the economic situation. Compared with the previous year, only government consumption will increase in 2009. Social transfers in kind supplied by market producers will post the largest real increase, partly as a financial consequence of measures adopted in the

second half of 2008 (subsidies for pupils' meals, free kindergarten care for the second child and all subsequent children attending kindergarten at the same time) and partly due to the higher real growth of expenditure on medicines. Real growth of the government intermediate consumption will slow somewhat compared with that in 2008, but will nevertheless remain relatively strong. The real increase in the compensation of public employees will be relatively modest, given that the growth in the number of employees in the public administration will slow significantly this year.

In most private sector activities, value added is expected to decline, most notably in manufacturing and construction. The key limiting factor to production will be low demand, both foreign and domestic, while the measures adopted in response to the crisis are mainly alleviating current financing difficulties of enterprises. A drop in construction activity will be the result of lower investment in motorways; however, construction of buildings will also decline. Decline in value added is also expected in market services, the largest in market services which are closely linked to domestic industrial and construction activities (business and real estate services, freight transport, wholesale trade).

Assuming that recession in the international environment will abate, the economy will post a slightly positive growth of 1.0% in 2010, with a gradual increase or a smaller drop in all consumption aggregates. Exports will strengthen in line with the anticipated economic recovery in Slovenia's main trading partners, particularly outside the EU area. Private consumption and investment will also start to rise at a moderate pace. Based on infrastructure construction plans for 2010, investment in motorways is expected to increase again; investment in railway infrastructure is also set to grow, while investment in energy infrastructure will decline. In the wake of the significant slowdown of construction investment in 2009, investment in new dwellings is not yet expected to increase in 2010. In 2010, investment in machinery and equipment is projected to stagnate, in line with the expectations that with a gradual recovery of economic activity in the second half of 2010 capacity utilisation will increase, though it will still be rather low, given the significant decline in the year before. A modest real growth of private consumption is projected to be a result of a slightly stronger wage bill growth despite a further drop in employment. However, in line with the current expectation for the duration of the economic crisis, consumers are likely to remain cautious when making major purchases. Owing to precautionary saving, the strengthening of household consumption will be slow. The increase in domestic consumption will, in addition to revived export activity, have an impact on higher imports.

Under the assumption of a global cyclical recovery, economic growth is projected to accelerate further in 2011. GDP is set to increase by 2.7%. With regard to the predicted improvement of the situation in the international environment, growth in exports of goods and services is expected to strengthen rapidly in 2011, but will remain below the levels recorded in the period since 2000. Investment of the business sector is expected to increase, particularly in the industry, which is also expected to have a favourable impact on investment in non-residential construction.

Against the background of the cyclical improvement of economic conditions, residential investment is expected to gradually strengthen again. With increased consumer confidence, private consumption growth is set to pick up in 2011. Stronger growth in imports of goods and services will thus be largely due to stronger growth in domestic investment amid higher export and production activity.

Table 2.3: Economic growth and related indicators

Change in %	ESA code	Level in 2007	2007	2008	2009	2010	2011
		Level in million EUR					
1. Real GDP	B 1 g		6.8	3.5	-4.0	1.0	2.7
2. Nominal GDP	B 1 g	34,470.9	11.2	7.7	-1.4	2.3	4.9
Real GDP components							
3. Private consumption	P3	17,984.4	5.0	2.2	-0.6	1.0	2.0
4. Government consumption	P3	6,095.6	2.5	3.7	3.2	3.8	3.2
5. Gross fixed capital formation	P51	9,477.5	11.9	6.2	-12.0	1.0	4.0
6. Changes in inventories and valuables (% of GDP)	P52+ P53		4.0	4.2	1.9	1.3	1.2
7. Exports of goods and services	P6	24,186.5	13.8	3.3	-8.6	1.7	5.4
8. Imports of goods and services	P7	24,635.9	15.7	3.5	-10.3	1.6	5.2
Contributions to real GDP growth (in percentage points)							
9. Final domestic consumption		-	6.3	3.5	-3.2	1.4	2.7
10. Changes in inventories and valuables	P52+ P53	-	1.8	0.2	-2.2	-0.5	-0.1
11. Balance of export and import of goods and services	B11		-1.3	-0.2	1.4	0.1	0.1

Source: SORS; Spring Forecast 2009, IMAD.

Assuming improved terms of trade, **the current account** deficit will narrow to 2.2% of GDP (EUR 809 million) this year. Lower current account deficit than last year will be mainly a result of a lower merchandise deficit. On one hand, merchandise imports are predicted to post a greater real decline than exports, on the other hand terms of trade are expected to improve significantly (by 3 index points). The surplus in services trade is set to post a decline, particularly in transport services, while the deficit in the group of other services is expected to widen. A lower deficit in current transactions will also be due to a lower deficit in factor incomes, which will be by our estimates a consequence of a much lower net outflow of dividends and reinvested profits from equity capital. Net interest payments to the rest of the world are projected to increase somewhat again, given the lower gross external assets in debt instruments compared with external liabilities. The improvement in current account deficit compared to previous year will also result from a lower deficit in current transfers. According to the supplementary budget, the state budget will realise a surplus against the EU budget. In 2010 and 2011, the current account deficit will be somewhat higher again, but significantly below the level of 2008. In the next two years, the higher deficit in current transactions will be mainly due to a deteriorated balance of merchandise trade. With approximately equal real growth rates of

merchandise exports and imports, the merchandise deficit is set to increase due to deteriorating terms of trade under the assumption of higher oil and non-oil commodity prices. The surplus in the services balance is expected to be somewhat higher, but the deficit in factor incomes will widen as a result of higher net interest payments to the rest of the world and a slightly higher net outflow of income from equity capital.

Table 2.4: Balances by individual sectors

% of GDP	ESA code	2007	2008	2009	2010	2011
Net lending / borrowing	B.9	-3.7	-5.6			
of which:						
Balance of imports and exports of goods and services		-1.3	-2.9	0.2	-0.6	-1.0
Balance of primary income and current transfers		-2.7	-3.0	-2.7	-3.2	-3.2
Balance of capital transfers		0.4	0.2			
Deficit / surplus of the private sector (ESA 95)	B.9/EDP B.9					
Deficit / surplus of the government sector (ESA 95)	B.9	0.5	-0.9	-5.1	-3.9	-3.4
Statistical deviation						

Source: SORS, Main Aggregates of the General Government, 2005-2008, 31 March 2009, First Release; Spring Forecast 2009, IMAD

The decline in economic activity in 2009 will also impact **wage dynamics** in the private sector, where gross wage growth will post a significant slowdown (to 0.1%). The forecast predicts that enterprises will try to tide over difficulties through streamlining their business operations and, even though trying to preserve jobs, also by cutting the number of employees, especially lower-skilled workers, so that the slowdown of the growth of the gross wage per employee will be relatively smaller than the decline in economic activity. Extraordinary year-end payments will also be significantly lower than last year. Real growth of the gross wage per employee in the public sector will remain relatively strong on average in the year as a whole (6.2%) due to the process of eliminating wage disparities, and will be mainly underpinned by the influence of high wage growth in 2008 and January's disbursement of the second quarter of funds to eliminate wage disparities. Nevertheless, further fiscal measures will also concern the wages in the public sector as outlined in Chapter 5. Even though public sector wages would, under the no-policy-change scenario, increase at a much faster pace than private sector wages, total gross wage growth would be consistent with labour productivity growth in 2010. Reaching 4.2%, nominal growth in the nominal gross wage per employee would exceed labour productivity growth by 0.2 p.p.; in real terms it would be 0.2 p.p. lower (2.6%). Amid the foreseen slow recovery of economic activity, the private sector wage will increase by a nominal 2.0% and by a real 0.4%. The gross wage per employee in the public sector would increase much faster also in the next year (by a nominal 8.5% and a real 6.8%) due to the process of eliminating wage disparities. In 2011, private and public sector wages will grow at fairly equal paces again, but growth of wages will lag behind labour productivity. Nominal growth of the total gross wage per employee (4.2%) will

lag behind nominal labour productivity growth (5.3%) by slightly over 1 p.p.; in real terms the lag will be even more pronounced (1.6% wage growth and 3.1% labour productivity growth). In the private sector, wages are projected to increase by 4.1% in nominal and 1.5% in real terms – in line with a further improvement of the economic conditions in the year with three fewer working days than the year before. In the public sector the wages are forecasted to increase by 4.4% in nominal and 1.8% in real terms.

Against the background of the tougher economic situation, the movements on the **labour market** are also expected to worsen this year, given that unemployment has been increasing again since last October. The number of persons in employment is thus projected to drop by more than 4% in 2009; without the measure of subsidising full-time work effective from the beginning of the year, this decline might have been even more pronounced. Owing to lower employment, the survey unemployment rate will increase from 4.4% to 6% and the registered unemployment rate from 6.7% to 8.9%, meaning that the number or registered unemployed might approach 100,000 by the end of this year. In 2010, the anticipated recovery of economic growth will not yet be reflected in average employment growth. In 2010, the average number of persons in employment will still be around 1.7% lower than this year. With a further decline in employment, labour productivity growth will nevertheless increase to 2.8% amid anticipated economic growth. Unemployment rates will increase once again: the survey unemployment rate to 7.0% and the registered unemployment rate to 10.3%. Employment will start to rise slowly at the end of 2011. The average annual number of persons in employment will be by another 0.4% lower than in 2010. Productivity growth will strengthen to 3.1%, but unemployment rates will remain high: the survey unemployment rate at 7.0%, the registered unemployment rate at 10.2%.

Table 2.5: Labour market trends

	2007 level (in 000)	2007	2008	2009	2010	2011
Employment (number of employees)[1], growth in %	962,6	3.0	2.9	-5.4	-1.7	-0.4
ILO unemployment rate, in %	50,5	4.9	4.4	6.0	7.0	7.0
Labour productivity (by the number of employees)[2]	35,8*	3.7	0.6	1.5	2.8	3.1
Compensation of employees		5.9	6.0	-2.1	0.9	1.3
Compensation of employees per employee		6.2	8.7	2.7	4.2	4.3

Source: SORS, Spring Forecast 2009, IMAD
Notes: * value in EUR 1000 [1] Persons in employment according to national accounts (domestic concept), [2] Real GDP

After a significant price shock stemming from food and oil prices at the end of 2007 with repercussions for 2008, the inflation converged back towards euro area average in the second half of 2008. During this period local interest rates in nominal terms increased gradually and remained on a relatively high level since the second half of 2008. **Inflation** is expected to slow further in 2009, mainly due to lower prices of oil and other primary commodities and moderate food price rises, but also as result of

shrinking economic activity. Inflation may also swing down sharply in the first half of the year, mainly owing to the base effect, i.e. strong oil price growth on the global market in the first half of 2008. Towards the end of the year, growth rates of consumer prices are set to increase again mainly due to the base effect, this time in the opposite direction than in the first half of the year. The spring forecast of year-on-year inflation at the end of 2009 is 1.4%, totalling 0.4% on average in the year as a whole.

Table 2.6: Price trends

Change in %	**2007**	**2008**	**2009**	**2010**	**2011**
1. GDP deflator	4.1	4.0	2.7	1.2	2.1
2. Private consumption deflator	4.1	6.5	0.2	1.5	2.6
3. Consumer price index	3.6	5.7	0.4	1.6	2.6
4. Government consumption deflator	2.1	5.3	4.1	4.9	2.8
5. Capital formation deflator	3.9	4.0	0.0	1.3	2.5
6. Export of goods and services deflator	2.9	1.8	-0.6	0.7	1.3
7. Import of goods and services deflator	2.3	4.0	-3.1	2.3	2.1

Source: SORS; Spring Forecast 2009, IMAD.

2.3. Medium-term scenario

The medium-term scenario of economic trends, which is the basis for projections in the Stability Program, is based on the Spring Forecast of Economic Trends and assumptions for the international environment in the baseline scenario, taking into account also economic policy measures that are already being implemented, which is in line with the Code of conduct of Stability and Convergence Programmes. Structural reform measures that are still being prepared are not taken into account in the baseline scenario.

Table 2.7: Key macroeconomic indicators until 2014

Average annual growth rates in %	**Scenario for the 2011–2014 period**
Gross domestic product	3.4
Export of goods and services	6.2
Import of goods and services	5.9
Private consumption	2.6
Government consumption	3.0
Fixed capital formation	4.7
Employment, growth in %	0.0
ILO unemployment rate, in %	6.9
Productivity, growth in %	3.4
Inflation, in %	2.7

Source: IMAD's projections, April 2009.

Taking into account assumptions for the international environment in the baseline scenario of the Spring Forecast and the adopted economic policy measures, economic growth after 2012 will rise again to just over 3.5%. Real growth of exports will be between 6% and 7% at the annual level, while real growth of private consumption will be around 3%. Infrastructure investment – in addition to motorway construction especially investment in modernising the railway infrastructure – will continue to be an important factor of the economic growth. Investment growth in real terms will be around 5%. The contribution of economic growth factors based on knowledge investment will increase gradually. Expected greater investment in research and development will also contribute to this. Rapid growth of business and financial services will continue. Further rapid growth of telecommunication activities is also expected.

2.4. Impact of structural reforms on growth

Structural reforms in line with the Reform Program for Achieving Lisbon Strategy Goals in Slovenia are part of the comprehensive strategic development framework, the basis of which is Slovenia's Development Strategy adopted in 2005. Their implementation continued in 2008, and in implementing the reform program the Government took into account recommendations adopted by the Council of the European Union when discussing the reform programs.

In addition to preserving macroeconomic stability, the Government is committed to improving the responsiveness of the economy to changes in the environment and to improving the conditions for growth of potential output. In recent years several measures that had a positive impact on improved competitive position of the Slovene economy have been put in place. The tax reform contributed importantly to lowering the burden of the economy (especially labour), tax relieves for R&D in enterprises are also higher. This was a step towards setting up systems conditions for achieving Lisbon goals, and especially for restructuring the economy in terms of greater technological complexity, greater human capital intensity, higher value added and employment. The national target of total R&D investment in the amount of 3% of GDP was postponed from 2010 to 2013 and the Government with further measures stimulates R&D co-operation between the research community and the economy.

The Government is striving for a more stimulating business environment for enterprises, which is improving with the implementation of the comprehensive program aimed at reducing administrative barriers and with measures for promoting entrepreneurship. In 2008, the one-stop-shop for establishing enterprises (i.e. VEM – "vse na enem mestu") was modernised by introducing the e-VEM system for companies. The new legislation enables easier access to financial resources, especially for small and medium-sized enterprises. Activities aimed at improving market competitiveness accelerated, which was enabled by the adoption of the new

and more efficient Prevention of Restriction of Competition Act. Competition in network activities is evident mostly in telecommunications; and recently also on the electricity market.

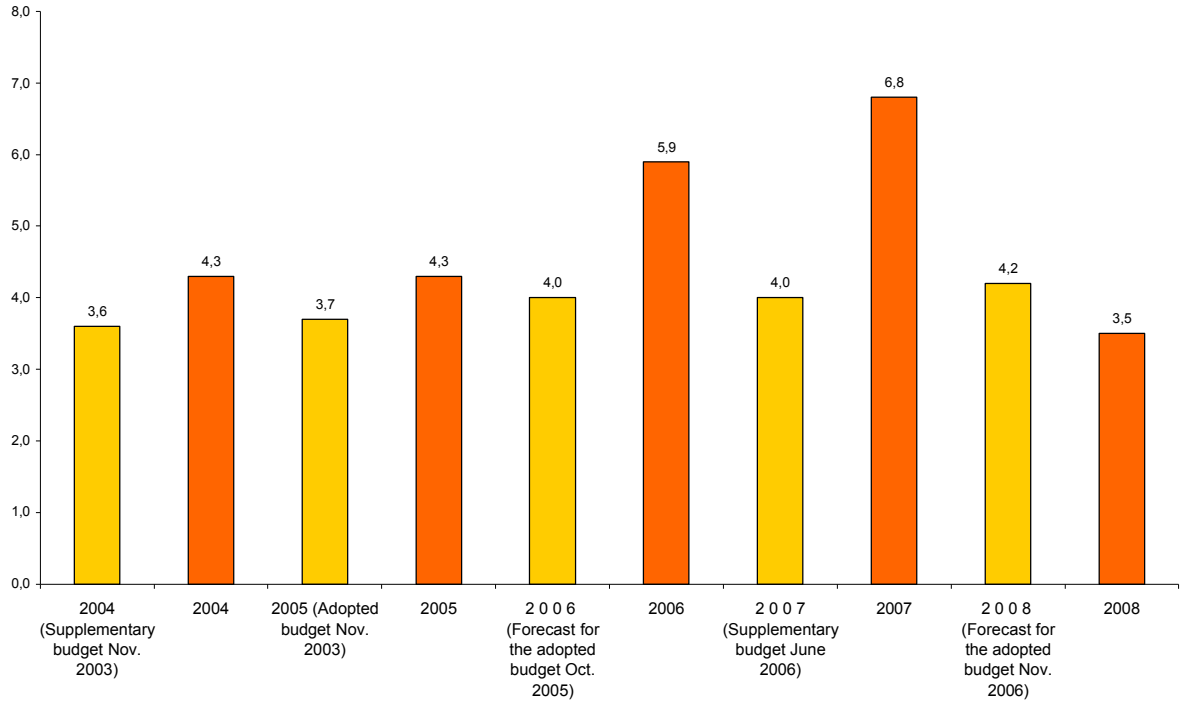
Advancements were made in the fields of educational structure of the population, employment and decrease in unemployment, while in the last months of 2008 some signs of slowdown of economic activity started to show on the labour market in connection with the deepening of the international economic crisis. Amendments of the Employment Relationship Act were a step forward to introducing the principles of flexicurity and greater labour market flexibility, and measures were adopted for stimulating activity of the population. The Government is aware of the problem of demographic changes and population ageing, which is why possible solutions for longer activity of the population, active ageing, and better labour market prospects for younger people are being prepared. According to the principle of life-long learning, the Government wants to enable people to be equipped with appropriate knowledge and skills in all periods of life and be better prepared for the challenges of the rapidly changing world. Therefore, with the modernisation of the education system, recognition of qualifications, improved system of awarding scholarships and other measures, the Government provides better quality of education, greater interaction with the economy and labour market, and greater inclusion of people.

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1. Policy strategy

Over the period 2004-2007 the economy exhibited a strong economic performance. Such a development facilitated fiscal consolidation on the one hand and to carry out and finance important changes in the tax structure. The general government balance turned from a deficit of 2.2% of GDP in 2004 into a surplus of 0.5% in 2007. This development took place on the back of: i) very tight wage policy in the public sector due to the postponement of the implementation of the Law (2002) that corrects wage disparities in the public sector; ii) conservative fiscal planning with budget outlays planned based on GDP forecast figures that lower than actual (see Figure 3.1); iii) lower transfers to individuals a result of better performance and change in indexation of transfers. As a result of these developments, the share of government expenditure in GDP declined from 45.8% in 2004 to 42.4% in 2007. In 2008 the declining trend in the expenditure-to-GDP ratio already reverted at the time when the implementation of the law of public wages over a three year period begun (2008-2010) and the economy stared to deteriorate. In the same year additional transfers to individuals were granted (Table 3.1). The worsening of economic conditions in 2009 will further increase expenditure pressures resulting from additional transfers to individuals particularly unemployment benefits.

Figure 3.1: Real GDP growth rates used in budget formulation and outturn



The strong economic performance and conservative budget planning facilitated the financing of the reduction of tax revenue arising from: changes in customs duties regime as part of the accession process to the EU; the elimination of the payroll tax; reduction of corporate income tax rate and; reform of the personal income tax regime. In particular, the increase in tax revenue from buoyant corporate income tax offset the bulk of tax revenue reduction coming from the first two tax measures. The changes in the tax system resulted in shifting the tax structure towards its more elastic components. This fact is particularly important in the current juncture where the business cycle is significantly affecting this type of tax revenues. In 2008, additional changes in tax regime were granted resulting in further reduction of tax revenue (i.e. tax allowance for low income earners and corporate income tax allowance). Therefore, as a result of the 2007 tax reform measures taking effect in 2009 and additional changes in 2008 the tax revenue in 2009 is strongly affected by the impact of institutional changes and not only by the business cycle (see Table 3.1). It should be stressed that tax reduction importantly unburdened tax burden on labor and enterprises.

Table 3.1: Past changes in tax and expenditure legislation affecting 2009 budgetary outcome

Measure	Revenues	Expenditure
Kindergarten support for families with more than one child (2008)		10,3
Subsidy for student meals (2008)		32,9
Elimination of wage disparities (according to 2002 Law)		204,4
Elimination of payroll tax (2006)	-231,3	
Reduction of CIT rate (2006)	-183,5	
CIT - additional investment allowance for companies (2008)	-41,8	
Increase of minimum allowance for low income earners (2008)	-11	
Total	**-467,6**	**247,6**

The fiscal policy of the new government has been shaped on the background of the financial crisis and of fast deterioration in the economic activity in Slovenia. The first set of measures addressing potential developments in the financial sector was adopted in November 2008 and recently upgraded in order to facilitate the credit flow to enterprises (Box 1).

Box 1. Government measures concerning the financial sector

The measures concerning the financial sector are of preventive nature and were adopted by the Parliament on 11 November 2008. They consist of an unlimited government guarantee to retail deposits and in empowering the government to take four types of policy measures subject to the endorsement of the relevant regulator. These are: i) loans to credit institutions, insurance companies, reinsurance companies and pension companies; ii) State guarantees to credit institutions; iii) capital investments in credit institutions, insurance companies, reinsurance companies and pension companies and; iv) purchase of claims from credit institutions. All measures are valid in the period up to 31 December 2010.

More recently in order to ease the credit conditions for enterprises the government decided to recapitalize SID bank (by 160 mio EUR) and the fund for entrepeneurship (by 45.2 mio EUR) as well as approved a guarantee scheme of 1.2 billion EUR for bank loans to enterprises for credits with tenure up to 10 years.

With regard to measures addressing the real sector the priority has been given to mitigate its impact on productive capacity and jobs. The first set of policy measures was adopted in December 2008 taking into account a sharp reduction in government tax revenues estimated at that time in 2.1 % GDP (0.9% GDP due to the business cycle and of 1.2% GDP due to changes in tax regime) and uncertainty in the financial markets. The aim was to attenuate the impact of the crisis in the real sector, primarily on jobs, while keeping the overall fiscal stance close to the 3% Treaty threshold. To achieve this, the 2009 supplementary budget approved in March includes a set of discretionary measures (subsidies and taxes) aimed at enterprises in the amount of 1.1% GDP (Table 3.2). This amount, once added to tax stimulus previously adopted

and being implemented in 2009 (Table 3.1), represents a total fiscal stimulus to enterprises of about 2.3 % GDP. On the other hand, to limit the worsening of the fiscal stance, the government increased excise duties as percentage of GDP by 0.9% and reduced the envisaged increase in wages of public sector to only 100 mio EUR in 2009. The government increase in excise duties has contributed to finance the reduction of payroll tax and thus to a shift in the tax structure from direct to indirect taxes.

Table 3.2: Discretionary policy measures to mitigate the impact of the crisis and fostering fiscal stability in 2009 (in mio EUR)

	Revenues	Expenditures
1. Policy to mitigate the crisis	**-68,2**	**397,9**
Additional unemployment benefits (allowances)		57
Labor subsidy for shorting hours worked		230,4
Enterprise restructuring (subsidies)		17,7
Fostering development of small companies and tourism		32,1
Subsidies for technological centers (R&D) and competition		60,7
Additional investment allowance for sole proprietors	-68,2	
2. Policy fostering fiscal stability	**343**	**-100**
Increase of excise duties	343	
Restraining wages in the public sector		-100
3. Total	**274,8**	**297,9**
4. Fiscal stimulus measure not affecting the deficit		**210,2**
Recapitalization of SID		160
Recapitalization of the fund of small enterprises		45,2

At the time of the approval of the supplementary budget in March the Institute of Macroeconomic Analysis released a new forecast for real GDP growth in 2009. The new figure of negative growth of 4% was worse than the one already provided previously and used for the elaboration of the supplementary budget (0.6%) and which was considered already low at the time.

The new low forecast for economic activity has important policy implications for the 2009 budget and for its evolution during the medium term. In absence of additional measures envisaged by the government and included in fiscal projections in this document, the deficit could remain well above the 3% threshold for the next three years leading to rapid increase in government debt. The impact of lower GDP forecast in 2009 is particularly significant in terms of tax and total government revenue losses. Comparing with the March supplementary budget, the total tax revenue further decreases by 1.6 percent of GDP and total government revenue by additional 2.2 percent of GDP. If we add the estimated fall in tax revenue at the time of elaborating the supplementary budget (2.1% GDP) to the additional decrease due to worsening in the forecast, the total loss of tax revenue will be of about 3.7% GDP.

Taking into account the worsening of economic conditions, the government envisages a fiscal policy over this a next two years that in line with economic recovery would

result in a gradual reduction of the budget towards the 3% Treaty reference value. This strategy is pursued in spite of relative low government debt that provides room for maneuver over the medium term. This is because running large deficits over the next years would result in interest payments crowding out existing rights and other budget allocations in the amount of 0.9% GDP. Other important considerations include the uncertainty regarding the economic recovery in Europe and market conditions that have indicated that access to the market is not always easy even for sovereigns with high credit ratings. While the key policy objective is to return below the Treaty reference value, the gradual reduction of the deficit will also contribute to reduction in the structural deficit by half from 2009 to 2011. Further and sustained effort would have to be maintained beyond the program period to return to the medium term objective. Such a task should be facilitated by the measures adopted by the government and economic recovery.

The policy followed this and next year where the crisis will be felt the most (real GDP growth is envisaged to be 2.7% in 2011) will pursue the following objectives: i) withdrawing the fiscal stimulus in line with economic recovery by 2011; ii) preserving jobs will continue to be the key priority within fiscal stimulus; iii) maximizing the withdrawal of EU funds for financing investment; iv) maintaining the size of resources for social transfers, excluding unemployment benefits, at the nominal level reached in first quarter of 2009 for this and next year; iii) rationalization of social transfers in favor of those more in need and; iv) reforming the wage policy in the government sector on a sustainable basis.

Given the challenge of population ageing the government will pursue the modernization of the pension system in a way that would contribute to long-term sustainability of public finances.

3.2. Medium term policy objective

The medium-term objective (MTO) for the cyclically-adjusted balance was set in 2005 at **–1% GDP**. The MTO set was more demanding than the minimum benchmark identified by the Commission for Slovenia (1.9% of GDP). In the previous update of the Stability programme it was claimed that the MTO was reached in 2007 and that it was going to be maintained over the programme period. This statement is not longer valid due to completely different ex-post and future evolution of the macroeconomic conditions (Table 3.3). In particular, most recent output gap estimates are completely different because they are based on lower and declining growth rates of potential output of the Slovenian economy. The comparison of cyclically adjusted balance between previous and this update highlights the issue of guiding fiscal policy based on ex-ante estimates of output gap and of the uncertainty of estimates of cyclical conditions.

Table 3.3: Output gap and cyclically-adjusted balance in the previous and current update

in % GDP	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
1. Output gap (previous update)	0.4	0.4	0.7	0.6	0.4	
2. Output gap (this update)	0.3	4.6	4.9	-1.9	-3.5	-3.3
3. Difference (2-1)		**4.2**	**4.2**	**-2.5**	**-3.9**	
4. Cyclically-adjusted balance (previous update)	-1.4	-0.9	-1.1	-0.8	-0.2	
5. Cyclically-adjusted balance (this update)	-1.4	-1.3	-2.9	-4.4	-2.6	-2.1
6. Difference (5-4)	**0.0**	**-0.4**	**-1.8**	**-3.6**	**-2.4**	

Table 3.4 shows estimates of cyclically-adjusted balance based on recent macroeconomic forecasts. It indicates that the cyclically-adjusted deficit will be halved during the program period but will remain above the MTO.

When comparing the drivers of growth base on decomposition based on recent production function estimates with previous update's estimates the result indicate that capital has an overwhelming importance in explaining potential growth. The contribution of total factor productivity on the other hand exhibits a decline in the level of contribution that took place in 2006 and 2007. Such a result seems at odds with progress made on structural reforms over the past years and with the result in the previous update showing a higher contribution of TFP than capital. The contribution of labor becomes negative in 2008 in both documents. Such a result might be explained by the sharp decline in GDP growth in 2009.

Table 3.4.: Cyclical developments

% GDP	**ESA code**	**2007**	**2008**	**2009**	**2010**	**2011**
1. Real GDP growth (%)		6.8	3.5	- 4.0	1.0	2.7
2. Net lending of general government	EDP B.9	0.5	-0.9	-5.1	-3.9	-3.4
3. Interest expenditure	EDP D.41	1.3	1.2	1.5	1.7	1.8
4. One-off and other temporary measures1						
5. Potential GDP growth (%)		3.3	3.2	2.7	2.6	2.5
contributions:						
- labour		0.1	-0.2	-0.2	-0.2	-0.4
- capital		2.7	2.7	2.5	2.4	2.4
- total factor productivity		0.5	0.7	0.4	0.4	0.6
6. Output gap		4.6	4.9	-1.9	-3.5	-3.3
7. Cyclical budgetary component		1.8	1.9	-0.7	-1.4	-1.3
8. Cyclically-adjusted balance (2 - 7)		-1.3	-2.9	-4.4	-2.6	-2.1

Source: MF RS.

3.3. Actual balances and implications

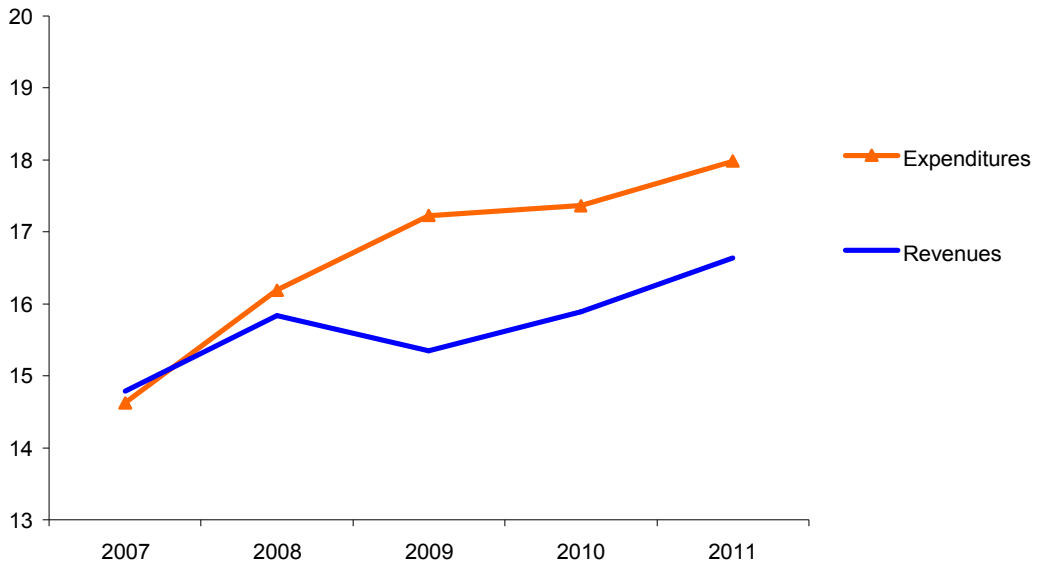
According to the revised statistical data the general government deficit in 2008 amounted to 0.9% GDP. This figure is identical to the deficit figure presented in SP

2007. Despite the fact that the figures are the same, the reasons explaining the deficit in the previous update and this document are different. On the revenue side tax revenue outturn was lower than planned primarily because of lower VAT revenue in the last two months of the year reflecting already the worsening of the economic conditions. This decline was partially offset by increase in personal income tax arising primarily from tax income from capital (dividend, interest and capital gains) that for two consecutive years grew by 80% annually. Corporate income tax revenue in 2008 was already lower than in 2007 reflecting slowing down in economic activity. Non-tax revenue on the other hand was higher than planned reflecting the still favorable juncture. On the whole government revenue was slightly higher than presented in the previous update.

On the expenditure side the compensation of employees already slightly increased (by 0.2% GDP) compared to 2007 level but was lower than in the SP 2007 as the implementation of the increase in wages was delayed. Social transfers were lower (0.3% GDP) due to the economic environment but also due to changes in indexation that took place already in 2007. Where important increases took place was in investments primarily by local community budgets in the amount of 0.6% GDP. On the whole total expenditures were higher than envisaged in the SP 2007. The high investment activity of local communities was reflected in the composition of the deficit between central government and local communities. In the SP 2007 it was planned that the whole general government deficit will incur at the central government level but at the end it was almost split in half.

The evolution of the public finances over the next two years and medium term will be importantly influenced by the magnitude of the shock to government revenue in 2009 as well as by the changes in the public sector wage system that had already taken effect and the level of social transfers. The strong effect of the crisis will be more visible on public finance in 2009 due to the cyclical conditions and policy decisions. The general government deficit in 2009 is estimated in 5.1% of GDP (Table 3.4). The government will submit a new supplementary budget in the next months including measures to rationalize expenditure. In the next two years, the gap between revenue and expenditures caused by the crisis (see Figure 3.1) and discretional policy changes will be partially closed nearer the 3% GDP deficit threshold. This will be done partially by phasing out the fiscal stimulus in 2011 and by policy measures built in the forecast. As a consequence the general government deficit will be -3.9% GDP in 2010 and -3.4% in 2011 (Table 3.1).

Figure 3.1: Total general government revenue and expenditures (bn EUR)



When looking at the estimates and forecast of balance by sector of the general government it is foreseen that the bulk of the deficit will take place at the level of the central government (state budget, extra budgetary funds, agencies and other entities at the level of central government). The central government deficit will gradually decline to below 3% by 2011. In the case of local governments their consolidated deficit will be lower than in 2008 (primarily due to high investment activity) and remain below 0.2% GDP. The Pension and Disability Insurance Fund (Pension Fund) will maintain a balanced position throughout the program period while it is foreseen that the Health Fund will run on average a deficit of 0.4% GDP during the program period (Table 3.4.).

Table 3.4.: General government budgetary prospects

	ESA Code	2007 Level	2007	2008	2009 (Suppl. Budget)	2009 (New Forecasts)	2010	2011
		mio EUR	% GDP	% GDP	% GDP	% GDP	% GDP	% GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	**162,5**	**0.5**	**-0.9**	**-3.7**	**-5.1**	**-3.9**	**-3.4**
2. Central government	S.1311	**135,3**	**0.4**	**-0.5**	**-3.3**	**-4.5**	**-3.5**	**-2.9**
3. State government	S.1312							
4. Local government	S.1313	**-33,3**	**-0.1**	**-0.4**	**-0.2**	**-0.2**	**-0.1**	**-0.1**
5. Social security funds	S.1314	**60,6**	**0.2**	**0.0**	**-0.3**	**-0.4**	**-0.3**	**-0.4**
General government (S.13)								
6. Total revenue	TR	**14.789,9**	**42.9**	**42.7**	**42.0**	**41.9**	**42.4**	**42.4**
7. Total expenditure	TE	**14.627,3**	**42.4**	**43.6**	**45.7**	**47.1**	**46.4**	**45.8**
8. Net lending / borrowing	EDP B.9	**162,5**	**0.5**	**-0.9**	**-3.7**	**-5.1**	**-3.9**	**-3.4**
9. Interest expenditure	EDP D.41	**442,6**	**1.3**	**1.2**	**1.4**	**1.5**	**1.7**	**1.8**
10. Primary balance		**605,1**	**1.8**	**0.2**	**-2.3**	**-3.6**	**-2.2**	**-1.6**
11. One off expenditures[5]								
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		**8.305,2**	**24.1**	**23.3**	**23.0**	**22.6**	**23.0**	**23.1**
12a. Taxes on production and imports	D.2	**5.024,5**	14.6	14.0	14.1	14.1	14.4	14.4
12b. Current taxes on income, wealth, etc	D.5	**3.272,0**	9.5	9.3	8.9	8.5	8.6	8.6
12c. Capital taxes	D.91	**8,7**	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	**4.813,7**	14.0	14.3	14.2	14.4	14.4	14.3
14. Property income	D.4	**247,0**	0.7	0.7	0.6	0.4	0.4	0.4
15. Other		**1.424,0**	4.1	4.3	4.3	4.5	4.6	4.6

[5] The adopted recovery measures include also a number of expenditure items, which could be regarded as temporary and one-off. These are spelled out in greater detail in Chapter 5. Nevertheless, it has been decided to factor these measures under regular expenditure items rather than one-off.

16. Total revenue	TR	**14.789,9**	**42.9**	**42.7**	**42.0**	**41.9**	**42.4**	**42.4**
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		**13.118,9**	**38.1**	**37.7**	**37.2**	**37.0**	**37.5**	**37.3**
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	**5.686,8**	16.5	16.9	17.5	17.9	17.7	17.5
17a. Compensation of employees	D.1	**3.641,0**	10.6	10.8	11.2	11.8	11.7	11.5
17b. Intermediate consumption	P.2	**2.045,8**	5.9	6.1	6.2	6.1	6.0	6.0
18. Social payments (18=18a+18b)		**5.626,6**	16.3	16.6	17.0	17.8	17.7	17.8
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D. 63131	**662,0**	1.9	1.9	2.1	2.2	2.0	2.0
18b. Social transfers other than in kind	D.62	**4.964,6**	14.4	14.7	14.8	15.5	15.7	15.8
19. Interest expenditure	D.41	**442,6**	1.3	1.2	1.4	1.5	1.7	1.8
20. Subsidies	D.3	**549,7**	1.6	1.6	2.5	2.7	2.2	1.7
21. Gross fixed capital formation	P.51	**1.290,3**	3.7	4.2	4.4	4.2	4.1	4.1
22. Other		**1.031,3**	3.0	3.2	3.0	3.0	2.9	2.9
23. Total expenditure	TE	**14.627,3**	**42.4**	**43.6**	**45.7**	**47.1**	**46.4**	**45.8**

Source: MF RS.

3.4. Debt levels and developments

The outstanding amount of general government consolidated debt was 8,473 mio EUR (22.8% GDP) at the end of 2008. The largest share (99.1%) of the total represents the central government debt which has a relatively sound structure[6]. The debt ratio is envisaged to increase significantly from the level reached in 2008 (22.8%) to 36.3% in 2011. The debt dynamics will be driven by the central government. While there was no outstanding debt of social security funds in 2008, the health fund is expected to incur debt which will represent 0.8% GDP by 2011. Local community debt is expected to remain slightly above the level reached in 2008 (0.9% GDP) and increase to 1.2% GDP in 2011. The indebtedness capacity of local government is constrained by the Law on Municipalities financing which limits the total amount of borrowing in a given year to a maximum of 20% of realized revenues in previous year. The debt service (interest and principal) is also subject to a maximum of 5% of realized revenues in the previous year[7].

The increase in general government debt-to-GDP ratio will be explained primarily by primary deficits over the period 209-2011. Another important factor in 2009 is the so called Snow-ball effect measuring the effect of the difference between interest and GDP growth in the debt dynamics due to positive increase in interest payments and negative GDP growth. The size of the stock-flow adjustment is relatively sizable in 2009 reflecting government operations linked to recapitalization of SID and Entrepreneurship fund and liquidity operations in support of the financial system.

Table 3.6.: General government debt developments

% of GDP	**2007**	**2008**	**2009**	**2010**	**2011**
1. Gross debt	23.4	22.8	30.5	34.1	36.3
2. Change in gross debt ratio	-3.3	-0.6	7.7	3.6	2.1
Contributions to change in gross debt ratio					
3. Primary balance	-1.8	-0.2	3.6	2.2	1.6
4. "Snowball effect"	-1.4	-0.5	1.9	1.1	0.2
5. Stock-flow adjustment	-0.2	0.1	2.2	0.4	0.3
p.m. implicit interest rate on debt	5.3%	5.4%	6.6%	5.8%	5.5%

Source: MF RS.

As part of the process of monetary integration, with the adoption of the euro in 2007, the infrastructure of domestic government debt market was further integrated to the EU market following the EMU targets on improvements of efficiency through harmonization process. In 2007 a new international structure of primary dealers was

[6] The average weighted years to maturity of central government budget debt was 5.78 years as of 31.12.2008 comparing 5.23 years as of 31.12.2007.

[7] The debt service (interest and principal) ceiling may be increased to a maximum of 8% of realized revenues in the previous year in the case of financing infrastructure investments in the field of schooling, housing, waste and water supply or projects co financed from EU budget. In such case the overall debt stock ceiling of maximum 20% does not apply.

established which includes 3 resident and 6 non resident banks. In 2009 the primary dealers group was increased to 8 nonresident banks. Newly issued bonds now trade on major international trading platforms.[8] The issuing strategy was modified by increasing the minimum issuance size as well as by changing the method of issuance to broaden investor base and increase market integration of Slovenia to the Euro area as well as to assure appropriate level of liquidity and transparency into the price formation process. Within the central government debt management a regular buyback program strategy was introduced. The purpose is to consolidate existing debt into fewer liquid benchmarks[9], to further support long run decrease of debt service cost, and to shape a debt portfolio structure that will further minimize exposure to market and macroeconomic risks. In March 2007 Slovenia issued its first EUR 1 bn benchmark government bond which successfully positioned Republic of Slovenia in the euro government bond market. The strategy followed at the time of entering the euro area and when the Slovenian debt market became part of the euro debt market has greatly benefit the government in tapping the financial market in 2009 at the time when financial crisis has deepened. In particular, investors already exposed to Slovenia are the ones that have participated in latest deals and the deepness of the market has facilitated financing borrowing requirement without major distortions.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

4.1. Sensitivity analysis to changes in economic activity

The baseline scenario of economic activity is described in Chapter 2 and represents the central forecast that is based on realistic assumptions and the most plausible outcome. Irrespective of that, the baseline scenario is subject to significant downside, and to a certain extent also upside, risks.

Due to Slovenia's high dependency on exports and its integration in international financial and economic flows the revival of domestic economic growth will depend the most on trends in the international economic environment and the efficiency of economic policy measures at the European and global levels. At this time the estimates of international institutions still show a high uncertainty with regard to the dimensions, depth and duration of the crisis. The risks that the international environment will see an even lower growth than assumed in the baseline scenario are thus higher than the possibility that the crisis will be shorter. The risks to the realisation of the Spring Forecast of Economic Growth in Slovenia for 2009–2011 thus remain very high and are distributed asymmetrically in the direction of lower-than-forecast growth. If the assumptions for the international environment continued

[8] In 2007 the link between local CSD and two pan-European CSD's (Clearstream and Euroclear) was established.

[9] In 2007 buybacks were executed in the amount of EUR 1 billion. In 2008 the amount was substantially reduced.

to deteriorate, economic growth in 2009 would fall by several more percentage points. The upside risk is the efficacy of anti-crisis measures in the international environment. If the packages aimed at stabilising the developments on financial markets start to work earlier than expected in the basic assumptions for the international environment, the economy may respond sooner or more vigorously than anticipated now.

In the event of lower economic growth in Slovenia's main trading partners by 0.5 p.p. in 2008, the real growth of Slovenian exports would be approximately 0.7 p.p. lower. Apart from that, the total real increase in gross fixed capital formation would also be 0.6 p.p. lower due to the slower real growth of private investment. Relatively smaller foreign demand would also dampen the growth of value added in manufacturing, which would reduce the growth of imports of intermediate goods. Consequently, the real growth of imports would slow down by 0.5 p.p. The total effect would result in 0.3 p.p. lower economic growth in 2008 relative to the baseline scenario.

4.2. Sensitivity of budgetary projections to different scenarios and assumptions

The sensitivity of budget projections to changes in variables affecting tax revenue is presented in Tables 4.1 and 4.2. The idea is to highlight the downward risk of macroeconomic scenario to revenue and budgetary projections which are particularly high due to the uncertainty in economic environment. The effect of the change in real growth of average (gross) wage, employment, GDP, private and government consumption was assessed.

Six scenarios were made (Table 4.1) highlighting potential current risks underlying the macroeconomic environment (scenarios 1-5) and the effect of fiscal policy changes (scenario 6): i) lower real growth rate of average wages; ii) non increase in employment (keeping employment in the economy at the same level as in the previous year); iii) lower real growth of GDP in t-1; iv) a lower real growth of private consumption of households; v) higher inflation (current and past years) and; vi) lower real growth of government consumption.

Table 4.1. shows the impact on the budget balance of negative changes in the mentioned macroeconomic variables channeled though different taxes considered independently. In all cases the negative trends affect tax revenue. By the relative size in total government revenue the highest risk is associated to social security contributions and indirect taxes. In particular, social security contributions are affected by lower real growth of wages, employment and inflation. This highlights the importance of current government stimulus to employment which is the variable the government can affect temporarily without creating major distortions. In the case of VAT, private consumption clearly is very important underpinning the importance of fostering confidence as part of the government strategy during the time of crisis.

Table 4.1.: Sensitivity of general government balance to changes in macroeconomic variables

Tax category	Macroeconomic base	Change in macroeconomic base	Change in general government balance in 2009 (% GDP)
Personal Income Tax	Real growth in average gross wage	Lower by 1 percentage point	-0.05
	Employment	Lower by 1 percentage point	-0.06
	Inflation	Lower by 1 percentage point	-0.09
	Last year's inflation	Higher by 1 percentage point	-0.04
Social security contributions	Real growth in average gross wage	Lower by 1 percentage point	-0.13
	Employment	Lower by 1 percentage point	-0.14
	Last year's inflation	Lower by 1 percentage point	-0.14
Corporate Income Tax	GDP growth in t-1	Lower by 1 percentage point	-0.05
	Last year's inflation	Lower by 1 percentage point	-0.05
Indirect Taxes	Real growth in private consumption	Lower by 1 percentage point	-0.11
	Real growth in government consumption	Lower by 1 percentage point	-0.02
	Inflation	Lower by 1 percentage point	-0.10

Table 4.2. shows the combined effect of changes in the macroeconomic variables in the budget balance channeled though various taxes and the effect of reduction in government expenditure. The impact is most pronounced in the case of inflation, a 1 p.p.. increase in inflation would lead to 0.33% lower revenue. Lower growth of wages and decline of employment also affect significantly the fiscal stance in a similar magnitude (0.22%). If we take into account the three mentioned variables which affect the budget balance significantly, it is possible to clearly assess the risk the current environment brings to the fiscal stance and the importance of cautiousness in fostering additional discretionary tax changes or providing additional tax allowances (See section on revenue). This is even more important taking into account their relative low multiplier effect. The simulation also suggests that if consideration would be given to the introduction of allowances to mitigate the social impact of the crisis, given the enormous shock to government revenues in 2009, a better approach would be to proceed by social transfers which are more likely to be temporary.

Table 4.2.: Cumulative sensitivity of general government balance to changes in macroeconomic variables

Macroeconomic base	Change in macroeconomic base	Tax category	Change in general government balance in 2009 (% GDP)
Real growth in average gross wage	Lower by 1 percentage point	Personal Income Tax, Social Security Contributions, Payroll Tax	**-0.19**
Employment	Lower by 1 percentage point	Personal Income Tax, Social Security Contributions	**-0.20**
Inflation	Lower by 1 percentage point	All	**-0.33**
Last year's inflation	Lower by 1 percentage point	Personal Income Tax, Corporate Income Tax	**-0.14**
GDP growth in t-1	Lower by 1 percentage point	Corporate Income Tax	**-0.05**
Real growth in private consumption	Lower by 1 percentage point	Indirect Taxes	**-0.11**
Real growth in government consumption	Lower by 1 percentage point	Indirect Taxes	**-0.02**

Source: MF RS.

4.3. Sensitivity analysis on the debt service

The outstanding central government debt is relatively insensitive to changes exchange rate as the share of debt denominated in other currencies (USD, GBP, CHF) is insignificant and will continue decreasing in the future. In the program period the share of debt with fixed interest rate will continue to increase from 98.8% in 2008 to 99.5% in 2011.

Provided there is no further worsening of financial conditions in the euro area, the major influence on the cost of servicing of existing debt and repayment of existing credits and securities in future will have the change of interest rates of the ECB and deficits. However, the effect of interest rate increase on debt service should not be high in the short to medium term given the term structure of the debt (primarily long term as the average term to maturity was 5.8 years at mid 2008). In the case of an interest rates increase of 100 basic points in 2009, this would lead to increase of cost of new borrowing in the level of 0.011% in the year 2010 and 0.08% in the year 2011. In the case that the deficit of the government would increase by 1 percentage point the interest cost as percentage of GDP would increase by 0.053% in the year 2010 and 2011.

Table 4.3: Sensitivity of interest payments and debt repayments of the general government (in % GDP)

	Change in interest rates		Change in deficit		Change in interest rates and deficit	
	Interest	Debt	Interest	Debt	Interest	Debt
2009	0.000	0.000	0.000	1.004	0.000	1.004
2010	0.011	0.011	0.052	1.033	0.072	1.053
2011	0.079	0.089	0.052	1.036	0.141	1.145

Source: MF RS.

It is clear from above that the existing central government debt is a relatively stable macroeconomic aggregate that is not strongly influenced by changes in exchange rate and inflation. The impact of change in variable interest rate is minimal as the bulk of general government debt has fixed interest rate. The change in interest rate affects primarily new borrowing.

4.4. Comparison with the 2007 Stability Programme

The forecasts of GDP growth for 2009–2011 projects a completely different reality than the one presented in the Stability Programme 2007. Already in the last quarter of 2008 the economy experienced a negative growth which just continues worsening in 2009. The forecast foresee a mild recovery well below the previous forecast of GDP growth. As a consequence of the change in the macroeconomic scenario the fiscal stance is completely different. Looking forward the room of maneuver created in the past in terms of debt-to-GDP ratio becomes smaller.

Table 4.4: Divergence from previous update (December 2007)

% of GDP	2007	2008	2009	2010	2011
1. Real GDP growth					
Stability program (previous update)	5.8	4.6	4.1	4.5	NA
Stability program (latest update)	6.8	3,5	- 4	1	2,7
Difference	1.0	-0.6	-8.1	-3.5	
2. General government net lending					
Stability program (previous update)	-0.6	-0.9	-0.6	0.0	NA
Stability program (latest update)	0.5	-0.9	-5.1	-3.9	-3.4
Difference	1.1	0.0	-4.5	-3.9	
3. General government gross debt					
Stability program (previous update)	25.6	24.7	23.8	22.5	NA
Stability program (latest update)	23,4	22,8	30,5	34,1	36,3
Difference	-2.2	-2.9	6.7	11.6	

Source: IMAD, SORS, MF RS.

5. QUALITY OF PUBLIC FINANCES

Over the past years we have witnessed a gradual process of fiscal consolidation underpinned by a strong economic growth, conservative budget planning (se figure 3.1) tight wage policy and a change in indexation of social transfers with the exception of pensions. The favorable environment facilitated the financing of the tax reform which significantly unburdened labour (Table 6.1), the change in the personal income tax into a dual tax system and a reduction of corporate income tax rates. These developments resulted in a gradual reduction of the debt-to-GDP ratio (22.8% GDP in 2008). In 2008 the process of consolidation discontinued partly explained by the deterioration in economic environment particularly in the last quarter of 2008, by higher investment of local governments and by the start in implementation of the law correcting wage disparity within the public sector over a three year cycle.

Table 5.1: Labour Tax Wedge

	Wage levels (% of average wage)				
Year	67%	Average	167%	300%	500%
2001	43.5	46.2	50.9	56.6	62.6
2005	41.8	45.6	52.3	59.0	62.1
2008	40.2	42.7	48.0	54.7	57.5
2009	39.9	42.5	47.6	53.3	56.1
Change 2001-2009 (in p.p.)	**-3.6**	**-3.7**	**-3.3**	**-3.3**	**-6.5**

In view of the economic deterioration, which has been fast over the past months, the government decided within the agreed EU framework to respond to the crisis by taking discretionary policy measures to mitigate its effects on the real economy. This response has been framed in a strategy that foresees a gradual consolidation over next years taking into account economic recovery. The policy response to the crisis has been careful taking into account the degree of openness of the Slovenian economy, prevailing financial conditions in the EU market, the relative available fiscal space (the debt-to-GDP ratio was 22.8% at the end of 2008) and past changes in tax legislation with effect on 2009. The response has focused on preserving the existing production capacity including jobs in a time frame that foresees the withdrawal of the fiscal stimulus from budget sources in 2011.

The choice of policy instruments by the relative importance in terms of fiscal impact (subsidies to preserve jobs and increase in investments financed with EU sources) responds to: i) the relative strength in terms of multiplier effect on the economy and effect on public finances position; ii) the more precise targeting and; iii) avoidance of entrenching the measures permanently. The policy also includes tax measures, but this was not the emphasis. This is because of: i) the relative low multiplier of tax changes in a small economy; ii) approved tax changes in the past with effect in 2009 amount to 1.3 GDP and; iii) a large impact of the cycle on loss of tax revenue (2.1% GDP). The policy package also increased expenditure in research and education to improve growth potential of the economy.

Table 6.2 shows the detailed discretionary policy action offsetting the effect of the crisis. It shows that the total effect of policy changes affecting tax revenue amount to 1.4% of GDP while the total effect of policy measures affecting government expenditures and the debt amounts to 2.1% of GDP. Adding policy measures concerning tax and government outlays, the total discretionary change will amount to 3.5% of GDP.

Table 5.2: Discretionary policy measures to stimulate the economy in 2009

	Revenues	Expenditures
1. Past changes in tax system with effect in 2009	**-466.7**	
2. Policy to mitigate the crisis	**-68.2**	**576.5**
Additional unemployment benefits (allowances)		57
Labour subsidy for shorter hours worked		230.4
Enterprise restructuring (subsidies)		17.7
Fostering development of small companies and tourism		32.1
Subsidies for technological centers (R&D) and competition		60.7
Additional investment allowance for sole proprietors	-68.2	
Additional investments from EU Funds (2009-2008)		178.6
3. Fiscal stimulus measure affecting the debt not the deficit		**210.2**
Recapitalization of SID		160
Recapitalization of the fund of small enterprises		45.2
Total (1+2+3)	**-534.9**	**786.7**
in % BDP	**-1.5**	**2.1**

The policy response is compatible with Lisbon goals as discretionary policy mitigates the crisis while placing emphasis on jobs. The measures are built on the undergoing process of tax reform aimed at unburdening labor and enterprises. However, due to the sharp reduction in tax revenue arising from discretionary changes approved in the past and the crisis, the government has decided to increase the excise duties which de facto served to finance the shift from labor tax to indirect taxes on a more sustainable basis. In particular, the increase in excise taxes compensates for the loss of revenue in 2009 due to the elimination of payroll tax. It is important to highlight also that policy changes with the exception of tax changes are of temporary nature. In particular, the subsidy for shorter hours worked is valid by law until 30 September 2009, although the government has indicated that it would prolong the measure if needed.

Notwithstanding the temporary nature of expenditures given the change in the trend of government revenue and underlying trends in government expenditure the fiscal policy for this and next two years is framed with a view to ensure fiscal consolidation. In particular, the envisaged policy will gradually reduce the gap generated from the shift in the level of government revenue (resulting from policy changes and caused by the crisis) and the trend in government expenditure underpinned by the implementation of the law correcting wage disparities and additional commitments approved in 2008. Policy measures affecting government expenditures can be

separated in those of a temporary nature until 2011 aiming at maintaining existing rights at current level and permanent policy changes contributing to fiscal stability. Among the first type of measure is the temporary freeze of indexation of social transfers and on more permanent basis is the reform of the public sector wage system (see Section on expenditures for discussion of the measures). Under the envisage policy the deficit of the general government will be reduced from 5.1% in 2009 to 3.4 in 2011% and the general government debt will increase from 22.8% in 2008 to 36.3% in 2011. Such a policy will minimize the crowding out effect of interest payments on existing budget entitlements to an additional increase of 0.6 percentage points of GDP until 2011.

5.1. General government revenues policy

In this program the budget forecast does not include changes to the tax system or tax rates besides those approved in the past which have budgetary effect this and next years. Besides the tax reform which was enacted in 2006 affecting currently corporate income tax and payroll tax additional changes to the tax system were introduced in 2008 and more recently in March 2009.

During 2008 two changes to the tax regime influencing revenue developments were introduced: additional general allowance for lower income groups and investment allowance for investment in equipment or intangible assets for unincorporated businesses and agriculture. The additional allowance for lower income group was EUR 1.000 for residents with active income more than EUR 8.300 and up to EUR 9.600; and EUR 2.000 for residents with active income of up to EUR 8.300. The fiscal impact was estimated in 2008 in lower revenues by EUR 60 millions. The investment allowance for investment in equipment or intangible assets is 30 % of invested amount, but only to the amount of a taxable base. The fiscal impact was estimated in loss of revenue of 30 millions EUR.

The most recent measure on tax system with fiscal consequences has been the increase in tax allowance for investment of sole proprietors. This measure is part of the fiscal stimulus to the economy. The fiscal impact of the measure in 2009 is EUR 68.2 million.

The government to offset the decline in government revenue rise excise duties on energy products, alcohol and tobacco. The impact of the change is EUR 444.8 millions. Table 5.3 shows the impact of institutional changes and the effect of the cycle in government revenue in 2009.

Table 5.3: Changes in government revenue in 2009

		Date
1. Changes due to 2006 tax reform with additional modifications in 2008		
-Lower CIT rates	-183.6	30.12.2008
-Phasing out of payroll tax	-231.4	22.11.2005
-Additional tax credit to lower income groups	-11.0	25.07.2008; 23.1.2009
-Additional investment allowance	-40.8	30.6.2008, 31.1. 2009
2. Changes in the new fiscal package		
-Investment allowance for sole proprietors	-68.2	27.06.2008; 30.12.2008
Excise duties	344.9	
-on energy products	310.9	15.12.2008, 29.12.2008, 12.1.2009, 23.2.2009, 9.3.2009
-on alcohol	20.0	27.1.2009
-on tobacco	14.0	3.4.2009
3. Revenue from EU funds		
-Increase in revenues due to higher withdrawals	508.3	np
4. Revenue shortfalls due to the cycle:	-772.1	
- PIT	-167.4	
- CIT	-103.6	
- Indirect taxes	-231.3	
- Social security contributions	-224.0	
-Other	-45.9	

Note: The data in the table is on cash rather than accrual basis.

Another tax measure implemented in the context of the fiscal stimulus package but without fiscal impact on ESA 95 methodology concerns corporate income tax procedure. This change allows companies to prepaid tax obligations with lower rate than originally stated by the law.

Another important institutional change without fiscal implications was the adoption a new Profit–Sharing Act in 2008. It regulates sharing of the profit of a company among employees and provides the tax incentives with regard to corporate income tax, personal income tax and social security contributions. Profit-Sharing Act determines two schemes of profit – sharing: one in the form of cash payments and the other in the form of number of shares in the company.

With regard to non tax revenue, the fiscal projections envisage maximizing the withdrawal of EU funds. For 2009 the amount included in the projections is EUR 508.3 millions (Table 5.3).

5.2. General government expenditure policy

Under the policy scenario presented in this document, the share of government expenditure in GDP will increase in 2009 and gradually decline towards the end of the program period. In 2009 the increase in expenditure will be sharp by 3.5 percentage points of GDP to a level of 47.1%. Then it will gradually decline to 45.8% in 2011. Nevertheless, the share of government expenditure in GDP will remain at the higher level than in 2008 (43.6% GDP).

The drivers underpinning the envisaged expenditure dynamics are the following: i) the approved reform in wage policy and its partial implementation until first quarter of 2009 with impact in the level of compensation of employees; ii) additional social transfers introduced in 2008; iii) worsening conditions with effect on social transfers; iv) increase in expenditure associated with fiscal stimulus package; v) increase of investments financed with EU funds; vi) increase in interest expenditure and; vii) policy measures aiming at ensuring fiscal stability.

The law correcting wage disparities in the public sector has been implemented so far partially. The law should be implemented over a three year period. The first wage increase was delayed in 2008 and the second increase took place as planned in January 2009. The second increase during 2009 has been postponed. Despite this fact the overall level of wage bill in GDP will increase by 0.7 basis points in 2009 compared to 2008 reflecting also lower nominal GDP than in previous year. The issue however, is that without the reform in wage policy envisaged in the program the share of the wage bill in GDP would be higher than the one presented in Table 3.5.

Additional rights pertaining social transfers were granted in 2008. In particular, a transfer for kindergarten support for families with more than one child and subsidies for student meals were introduced. The fiscal impact of this measure will be 43.2 mio EUR in 2009.

Total expenditure will increase also temporarily due to the worsening of economic conditions in the form of higher unemployment benefits but also due to fiscal stimulus package (Table 3.2). However, given the weak economic recovery even when phasing out these measures in 2011, the share of expenditure in GDP would not fall fast enough without the measures described below. The share of expenditure in GDP will also increase due financing investments with EU funds, but in this case the effect on economic activity will be favourable.

As mentioned earlier the key policy in the stimulus package is to support jobs not encourage unemployment. It consists of subsidizing shortening of working hours by conditioning enterprises receiving it not to lay off workers. Enterprises not participating in the scheme can opt for alternative policy. The scheme is perceived as temporary and more targeted than for example reducing social security contributions and has less risk to be entrenched.

The other key policy is the increase of financing of investments with EU funds. The nominal increase in 2009 will be higher and will add to the relatively high nominal amount of investment in 2008 financed with budget resources. Table 5.4 shows also that investments with EU sources will remain relatively high in nominal and in terms of GDP over the next two years. It is also important to highlight that the share of gross fixed capital formation in GDP will remain at a relatively high level when the economy will start to growth again in the next two years.

Table 5.4: Investment and investment transfers financed from EU resources

	2007	2008	2009	2010	2011
in mio EUR	101	275.5	454.1	648.2	486.5
in % GDP	0.5	0.7	1.2	1.7	1.2

Offsetting the underlying trend in government expenditure and gradually aligning it with recovery in revenues in accordance with improving of economic conditions over the next two years, requires the adoption of further measure by the government to those included in the March supplementary budget.

The overarching objective of the policy measures is to preserve the safety net and rights over crisis period by combining temporary and permanent solutions on various expenditure items. The measures are twofold and concern (Table 5.5): i) the nominal amount allocated for social transfers rather than unemployment; and ii) reform of the wage system in the government and constraining expenditure in goods and investment (from budget sources).

The first type of measure responds to the low inflation and growth environment which will not touch on existing rights. The nominal amount allocated to wages in government sector, pensions and social transfers will remain constant at the level reached in the first half of 2009. The measure will be in force until 2011.

Within the second set of measures a reform of the wage system will be implemented in a way that it is consistent with public finance stability over the long-term. Purchases of goods and services will be further rationalized and the size of investment finance with domestic sources will not increase over the next two years, but will remain at a relatively high level.

Table 5.5: Additional measures to ensure public finance stability in 2009 and 2010

in mio EUR	**2009**	**2010**
1. Maintaining the nominal value of existing budgetary allocation	7.0	184.5
- wages	0.0	15.0
- pensions	0.0	150.0
- social transfers	7.0	19.5
2. Government consumption and investment		
-Prolongation of the reform of the public sector wage system	0.0	201.0
- Lower expenditure on purchase of goods and services	139.6	172.5
- Adjustments to investments	192.2	312.6
3. TOTAL	**338.8**	**870.6**

Source: MF RS.

6. SUSTAINABILITY OF PUBLIC FINANCES

In view of the current crisis the challenge of population aging assumes grater proportions. This is because, the declining path of debt-to-GDP ratio is reverting and the debt is going to increase substantially in the programme period. Similarly important is that the crisis might reduce progress made on labor participation over the past years. While the agreed EU three–pronged approach to tackle the demographic challenge remains a key policy orientation the balance among its components clearly shift towards amending existing parameters in pension system[10]. Given the impact of the crisis on fiscal balance spread over the medium this also means that the menu of options for shaping possible alternatives to changes (e.g. second pillar initiatives) to the pension system are very few. This is particularly relevant due to the evolution of headline deficit and debt dynamics in the current juncture where financial markets are disfunctional. To address the issue of unsustainable evolution of pension cost in the future, the government has set a group of experts which shall present by fall proposal to modernize the pension system on a sustainable basis. The proposals should be built upon the 1999 pension reform which measures are being implemented until 2015.

This section presents updated baseline projections related to age related expenditure, various simulations on the base line scenario to show the impact of different policy measures on pension costs and benefits and the last section indicates the strategy of the government in the field. The baseline projections are based on most recent population projections of Eurostat of Spring 2008 (Table 6.1) and taking into account agreed assumptions in the ageing working group (Table 6.2) and recent budgetary developments.

[10] Consisting of: i) fiscal consolidation and debt reduction; ii) increased employment and iii) pension and related reforms.

Table 6.1.: Eurostat demographic projections by age groups 2008–2060

Year	TOTAL	0 - 14	15 - 59	60+	80+
2008	2.022.644	280.865	1.314.228	427.551	71.176
2020	2.058.003	291.580	1.200.415	566.008	111.320
2030	2.022.872	258.508	1.110.151	654.213	135.110
2040	1.957.942	235.960	1.005.948	716.034	193.333
2050	1.878.003	239.902	898.509	739.592	224.641
2060	1.778.573	227.648	857.263	693.662	246.372

Source. EUROSTAT, New Cronos and own calculations; © Statistični urad Republike Slovenije

6.1. Baseline projections

The new population projections of Eurostat compared to previous one show the following changes over the period 2008-2060: i) doubling of the share of population aged 60; ii) four times increase in the share of individuals age 80 years and; iii) decline in the share of population age 15 to 59.

Table 6.2 presents the updated base line projections of age related expenditure. The increase of pension expenditure between 2007 and 2050 is estimated in 8.3 percent of GDP. This figure is higher than the one presented in the stability program 2007 (6.1 percent of GDP). Total expenditure in pensions will further increase to 8.3 percent of GDP by 2060. The trend increase accelerates about the year 2025.

The projections result from several factors: i) the dependency ratio; ii) coverage ratio; iii) employment activity and; iv) benefit ratio. The key factors explaining the share of pension expenditure in GDP are the dependency and activity rates. This underpins the importance of labor market policy in fostering participation. In particular in the SP 2007 a simulation was performed by which it was assumed that Slovenia would achieve by 2050 similar participation rates than those observed (2005) in the most advanced EU Countries.[11] Under the simulation total old age and pension expenditure in the period 2006-2050 compared to the baseline scenario reduced by 2.4% of GDP and 1.6% respectively.

[11] Long-term sustainability of public finances in the European Union EUROPEAN ECONOMY. No. 4. 2006

Table 6.2: Long-term sustainability of public finance, % GDP

	2007	2008	2009	2010	2020	2030	2040	2050	2060
Total revenue	**41.76**	**41.28**	**40.52**	**40.59**	**41.54**	**41.81**	**41.71**	**41.26**	**40.98**
Pensions	10.10	10.22	10.25	10.31	11.24	13.42	16.30	18.39	18.83
Old-age	7.01	7.16	7.24	7.32	8.44	10.44	12.93	14.70	15.05
Disability	1.54	1.51	1.49	1.48	1.36	1.25	1.27	1.28	1.23
Family	0.90	0.91	0.90	0.89	0.84	1.03	1.27	1.46	1.57
State	0.10	0.10	0.10	0.10	0.11	0.15	0.17	0.20	0.21
Other	0.55	0.53	0.52	0.53	0.49	0.55	0.66	0.74	0.77
Healthcare	5.81	5.81	5.83	5.90	6.45	7.32	8.27	8.99	9.30
Long-term care	0.76	0.77	0.78	0.80	0.97	1.20	1.53	1.81	1.99
Education	5.39	5.32	5.22	5.17	5.09	5.23	5.05	5.34	5.60
Interest expenditure	1.06	0.69	0.66	0.65	0.63	1.17	3.15	6.97	12.46
Total expenditure	**41.49**	**41.13**	**40.99**	**41.07**	**42.41**	**46.34**	**52.34**	**59.54**	**66.21**
Assumptions									
Labour productivity growth	3.6	3.7	3.6	3.7	3.1	1.8	1.7	1.7	1.7
Real GDP growth	4.8	4.6	4.5	3.4	2.6	0.8	0.7	0.8	1.1
Participation rates males (aged 15-64)	75.8	76.3	75.8	75.4	75.8	74.2	73.0	73.9	74.3
Participation rates females (aged 15-64)	66.7	66.9	67.5	68.0	70.8	69.1	68.4	69.3	69.5
Total participation rates (aged 15-64)	71.4	71.7	71.8	71.8	73.4	71.7	70.8	71.6	71.9
Unemployment rate	4.9	4.9	4.6	4.6	4.6	4.5	4.5	4.5	4.5
Share of population aged 65 years and over (%)	15.9	16.1	16.4	16.6	20.4	25.3	29.1	32.5	33.4

Source: IER, UMAR, MF RS.

6.2. Simulations

With the purpose to illustrate the possible effect of different measures available to mitigate the impact of ageing on pension expenditure and total expenditure related to ageing, various policy scenarios were made on the baseline scenario. The simulations do not refer only to the impact of a particular measure on the cost but also on its impact on pension benefit as measured by the replacement rate: the ratio between pensions to wages. Such an approach provides a more comprehensive view regarding the issue of long term sustainability. Reducing pension benefits in the long term below acceptable levels does not properly address effectively the issue of contingent liabilities.

The policy scenarios relate to changes in the parameters of the Pay-as-You-Go system and include: 1) Base line scenario; 2) Higher Life Expetancy Scenario; 3) Increase in the retirement age by one year; 4) change in pension indexation to 80% of wage[12]; 4) increase in labor participation rate; 5) Increase in labor participation rate; 6) Increase in retirement age and higher labor participation rate and; 7) 80% wage indexation, increase in retirement age, higher labor participation rate.

Figure 6.1 shows the result of different scenarios and measures. The measures, independently considered and ranked according to their relative strength, show that indexation is the most powerful measure followed by increase in retirement age and increase in the labor participation. Accordingly, the replacement rate is affected with the relative strength of the measure (Table 6.3). Notice, however, that increase in retirement age and participation rate do not substantially decrease the replacement rate when compared to the base line scenario. This is particularly the case of increasing participation. When combining all measures in scenario 7, total expenditure related to old age decreases by 3 percentage points and expenditure in pensions by 2.3 percentage points. Notice however, that even in this scenario age related expenditure is still high and the replacement rate decreases close to 50%. This reflects the policy challenge ahead.

[12] Currently the growth of the basic pension follows wage growth; however the increase on average pension is being downward corrected by an adjustment prescribed by law (art 151) which aims at equalizing the rights of pensioners retired in different periods. As a result the average replacement rate should fall until 2025 when the 1999 pension reform would be fully implemented.

Figure 6.1: Sensitivity scenarios on change in old-age expenditure (% GDP)

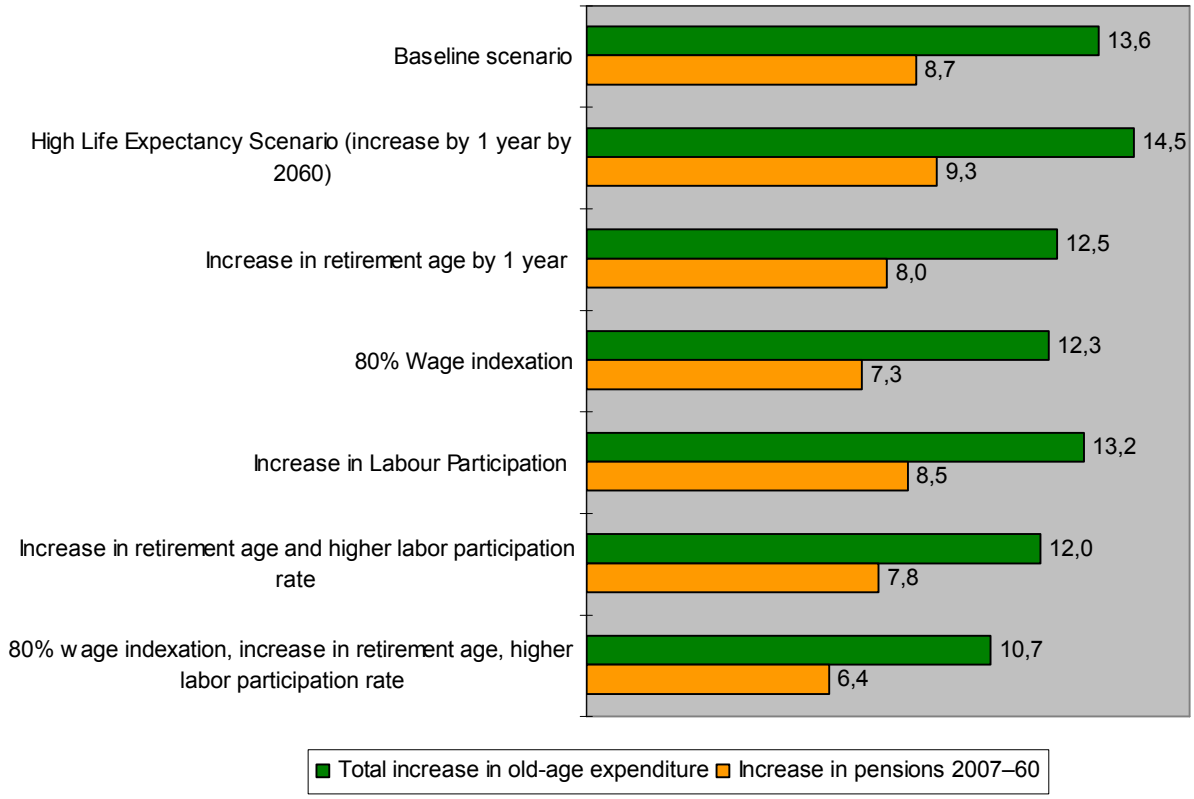


Tabela 6.3.: Sensitivity scenarios – change in old age expenditures

	Total increase in old-age expenditure 2007–60	Increase in pensions 2007–60	Replacement rates		
			2007	2050	2060
Baseline scenario	13,65	8,73	63,6	56,6	57,0
High Life Expectancy Scenario (increase by 1 year by 2060)	14,52	9,31	63,6	56,7	57,1
Increase in retirement age by 1 year	12,49	8,00	63,6	54,9	55,5
80% Wage indexation	12,26	7,34	63,6	52,4	52,8
Increase in Labour Participation	13,22	8,53	63,6	56,5	56,9
Increase in retirement age and higher labor participation rate	12,03	7,76	63,6	54,9	55,4
80% wage indexation, increase in retirement age, higher labor participation rate	10,71	6,44	63,6	50,8	51,3

Source: IER, UMAR, MF RS.

The impact of the two scenarios on sustainability of public finance can be also assessed in light of the S1 and S2 indicators used by the EU Commission to estimate the fiscal effort (primary balance) necessary to keep the debt below 60% up to 2050 (S1) and to ensure that the intertemporal budget constraint is observed (S2). Table 6.4 shows the impact of policy measures in the various scenarios. It also include an estimate f the downward adjustment to pension growth resulting from the measure aiming at equalizing pension benefits among cohorts contemplated in the existing pension reform.

Table 6.4: S1 and S2 under increased different scenarios

	S1	S2
Base line scenario	2,99	7,01
Increasing retirement age by 1 year	2,31	6,06
Increase in labor participation rate	2,60	6,56
80% wage indexation	2,40	6,16
Increase in retirement age and higher labor participation rate	2,04	5,70
80% wage indexation, increase in retirement age, higher labor participation rate	1,46	4,87
80% wage indexation, increase in retirement age, higher labor participation rate and new demographic scenario	1,58	5,16

Source: IER, MF RS

6.3. The government strategy

The government has set a group of experts which shall present by fall proposal to modernize the pension system on a financial sustainable basis. Policy effort is also being placed in fostering a relative fast fiscal consolidation taking into account the adverse macroeconomic scenario. Similarly, policies are aimed at minimizing the shock on employment and policies will enhance participation of older generations in the labor market by for example encouraging life long learning. In this time of crisis the clear policy priority is to minimize the loss of jobs.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Amendments to the Law on Public Finanes

The Law on Public Finances, originally adopted in 1999 was the first sistemic act of its kind in Slovenia. After more that 10 years, time has come to introduce amandments in upgrade the existing framework. The new government intends to systematically tackle a number of issues. Firstly, the new Law will upgrade the existing definitions (the scope of public finance, definitions on central government, definitions on debt, etc.) and a number of adjustments will have to be made for

relations with the EU budget as the EU funds are not treated separately under the current law.

All general government tables will be upgraded from the current GFS 86 methodology to GFS 2001. Another novelty will be the gradual introduction of accrual principle for accounting purposes in the general govenrment tables, while also maintaining all flows on cash basis. The balance sheet will become a compulsory feature for the entire general government sector.

A number of changes will be made in the area of debt, starting with the indebtedness of municipalities, the Pension Fund and Healthcare Fund thereby systamatically putting in place a framework of general government debt. New definitions on state debt and debt assumptions will be introduced. Given the good track-record of the single treasury account, certain modifications will be introduced including its extension to ther legal entities.

7.2. Performance-based budgeting

The idea of introducing performance budgeting has regained importance. The new government is considering its introduction in the preparation and implementation of the budget. In August 2007 a working group was established to review the system of indicators for the quality of public spending and monitor the achievement of the goals set by the budget users. The group's main tasks included: (i) revision of indicators for the quality of public spending and participation in the determination of budget users' objectives so as to ensure a connection between political priorities and the distribution of public funds; and (ii) monitoring the achievement of the set goals and the related results, thereby introducing programme-based budget planning.

At the same time, the government in 2007 adopted a new institutional setting for the longer-term development planning including the possibility to monitor the implementation of development policies. Based on this the government intends to introduce a system of development planning, which could monitor: i) all longer-term development strategic and implementing documents at the level of policies, programmes, subprogrammes and measures and ii) their realisation and effectiveness. Thereby the new system will enable:

- a more efficient setting of priorities, and
- a new, more development-oriented budgeting.

These changes will be reflected in all key strategic documents. The new govvernment therefore intends to amend the National Reform Programme 2008–2010 as well as its implementing documents.

At the same time the new government intends to implement fully performance-based budgeting in the next budgetary cycle 2010–2011. The first step in this respect will be

the establishment of a single record and a new approach to setting up performance-based budgeting.