THE REPUBLIC OF SLOVENIA

STABILITY PROGRAMME

2009 Update

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FOREWORD

The 2009 update of the Stability Programme differs from the previous updates. Slovenia has been formally under an excessive deficit procedure since 2 December 2009. In line with the recommendations made by the Council, Slovenia has to bring down the deficit below 3% of GDP by 2013. The key challenge for the government in the next four years is fiscal policy that will primarily lead to the consolidation of public finances. Stability programme includes the policies and measures that the government will implement in the next four years with the aim to bring down the government deficit below the reference value. The main objectives of the economic policy measures are macroeconomic stability and fiscal consolidation taking into account the 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 and the Recommendations of the Council for bringing an end to the situation of an excessive deficit in Slovenia.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

Slovenian economy has been hit hard by the international financial crisis and the collapse of external demand. The economy already faced negative growth in the last quarter of 2008, which turned into recession by the first quarter of 2009. Propelled by the stabilization of economic conditions in Europe and countercyclical fiscal policy on top of automatic stabilizers, the economy registered weak positive growth during the second and third quarter of 2009. The economy is estimated to have shrunk by 7.3% in 2009, one of the highest negative real GDP growth rates in the euro area. The severity of the impact is explained by the degree of external openness of the economy, the structure of exports and the transmission of the collapse of external demand on domestic production, investment and private consumption. Going forward (2010-2013), a modest economic recovery is envisaged associated with a weak and uncertain international environment and the pace of normalization of financial conditions.

The severe economic downturn has resulted in a sizable permanent loss of revenue and a fall in its level below historical trends. The size of revenue shortfall due to the cycle alone in 2009 was close to 2.5% of GDP. In absence of compensating policy measures, it will take up to half a decade for government revenue to return to its past trend. The fall in revenue reflects not only the effect of the crisis, but previous changes in the tax system. While the implementation of previously agreed tax reduction in 2009 contributed to the countercyclical effort, looking forward it impinges on the speed of fiscal consolidation. Similarly, the magnitude of the revenue shortfall under a weak economic recovery limits severely the scope of pursuing reforms that would further reduce the overall tax burden on the economy over the medium term.

Despite the large fall in revenue the government has decided not to rely on tax increases to pursue fiscal consolidation over the medium term. Tax increases could hinder the economic recovery. The tax burden will be kept on the current level throughout the program period. Thus, in order to reduce the deficit below the 3% of GDP reference value according to Stability and Growth Pact and close to balance over the medium term, the government will rely on **an expenditure-based fiscal consolidation strategy**.

To mitigate the impact of the crisis on the economy and built on the 2006 tax reform that envisaged tax rate reductions in 2009, the government enacted in 2009 a series of targeted and temporary measures for the years 2009-2010. The policy also included measures aimed at limiting and rationalizing expenditures and offsetting tax revenue decline. In particular, previously agreed changes affecting positively the public sector's wage bill were limited or postponed. Similarly, expenditure on goods and services was rationalized. Intervention legislation was adopted to limit the growth of transfers to individuals to one half of inflation and growth of pensions to one half of wage growth. On the revenue side excise duties were increased, additional tax allowances were introduced and the deadline for VAT refund was shortened.

Policy intervention concerning the stability of the financial sector and aiming at facilitating the credit flow to the economy was and remains key to stability and recovery. A full deposit guarantee to retail depositors enhanced confidence, while

treasury operations with impact on debt dynamics provided liquidity to the system at a time when the international financial crunch was most severe. State guarantees in favor of financial institutions and state guarantees schemes for enterprise sector and for individuals were also introduced to enhance the credit flow to the economy. Given that the Slovenian banking system's exposure to toxic assets (impaired assets) was limited, no intervention measures are envisaged to this purpose. On the other hand, activities for capitalization of banks where state holds shares continue, with the aim of strengthening the capacity of the financial system in the process of economic recovery.

In view of the incipient but still uncertain economic recovery and gradual normalization of financial market conditions, the policy objectives in the period 2010-2013 are threefold:

i) ensuring the gradual withdrawal of fiscal stimulus by the end of 2010 and gradual phasing out of financial support measures;
ii) implementing an expenditure driven fiscal consolidation strategy that would ensure eliminating the excessive deficit to below 3% of GDP by the year 2013 and;
iii) underpining long-term fiscal consolidation and potential growth by the implementation of the structural reform agenda.

The withdrawal of fiscal stimulus by the end of 2010 is already imbedded in the 2010 and 2011 adopted budgets and as a consequence, the general government deficit in 2011 is 1.5% of GDP lower compared to 2010. Nevertheless, given that the impact of the crisis is still unfolding, particularly on the labor market where unemployment typically lags behind developments in the real economy and where there is risk of temporary unemployment becoming permanent, efforts will be placed to foster activation and skills programs within the foreseen consolidation path. Similarly, within the budget constraints efforts will be placed to provide room for continued financing of short-term responses to the crisis that proved to be useful and compatible with longer-term development goals.

Measures to the financial sector will continue to be implemented in accordance with the EU framework and most notably Ecofin Council conclusions from December 2009. They will be phased out gradually in line with improvement in financial conditions. Efforts will be placed in minimizing moral hazard and limiting the budgetary exposure to direct or implicit liabilities beyond the current level and in the absence of extraordinary events no further measures will be enacted.

The process of expenditure driven fiscal consolidation will be underpinned by policy aimed at enhancing the quality of public finances. The recently approved development-oriented program budgeting will contribute to this end.

An important component of the fiscal consolidation that at the same time will underpin economic recovery will be to enhance and maximize withdrawal of EU funds to finance investment. The investment level will be maintained as it has direct bearing on potential growth but its financing composition will shift towards EU funds. Similarly, rationalization of programs and expenditure switching will be made in favor of development-oriented components.

The success of the consolidation effort including the withdrawal of fiscal stimulus in 2010 depends to a great extent on implementing the structural reform agenda. Structural reform agenda influences both the growth potential and sustainability of public finances. While there is some overlapping between some polices implemented in the short run as a response to the crisis, particularly on labor market, structural policy is typically oriented over the longer term as its effect on growth potential takes time to materialize or its effect on public finances is not perceived in the short-term. Nevertheless, structural reform measures that can have a positive impact on the public finances in the medium and long term will be given priority during the period 2010-2013. This involves in particular further reform of the pension system and health reform, as well as reform of the public sector and social security rights. Changes in the pension system (e.g. pension's indexation formula) and health system (expenditure and widening of tax base for social security contributions) will contribute to fiscal consolidation in the short-term and to long-term sustainability of public finances.

The implementation of structural reform geared towards mitigating the impact of the crisis on growth potential is particularly critical. Within the budget constraint and taking into account changes in the preparation of the state budget including program based classification, resources will be reoriented to education and skills, better reflecting labor market needs, research and innovation, environmentally friendly technologies, resource efficiency and renewable energy.

2. ECONOMIC TRENDS AND FORECASTS OF MACROECONOMIC AGGREGATES[1]

2.1. Assumptions about the international environment

The macroeconomic forecasts in the Stability Programme arise from the Autumn Forecast of Economic Trends 2009 (IMAD, September 2009), which is based on the assumptions of international economic developments according to the forecasts published by international institutions by mid-September 2009 (see Table 2.1). These assumptions envisage a gradual recovery and modest economic growth in Slovenia's main trading partners for 2010. The gradual recovery of economic activity in Slovenia's export partners is projected to pick up in 2011 and economic growth will remain at the achieved level also in 2012. The forecasts by international institutions for individual countries that were published after the Autumn Forecast had been finalized (European Commission, November 2009; OECD, December 2009; Consensus, November 2009) are somewhat higher than the assumptions in the Autumn Forecast, particularly for 2010, though simultaneously emphasizing the high risks of another significant decline in economic activity related to the expiry of anti-crisis measures, further negative movements on the labor market, the still uncertain situation on financial markets and low lending activity. In view of the high uncertainty associated with the recovery of the European economy and the available data and

[1] The macroeconomic aggregates are forecasted based on no-policy-change concerning fiscal 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.

forecasts, we estimate that the forecasts for export activity and thus the Autumn Forecast of Slovenia' GDP should not yet be revised.

Table 2.1: IMAD's assumptions on economic growth in Slovenia's main trading partners in 2009–2011

	2008	2009	2010	2011
		Autumn forecast 2009 (Sept. 2009)	Autumn forecast 2009 (Sept. 2009)	Autumn forecast 2009 (Sept. 2009)
EU	0.9	-4.2	0.2	1.6
Euro area	0.7	-3.9	0.4	1.6
Germany	1.3	-4.8	0.9	1.5
Italy	-1.0	-5.2	-0.2	0.9
Austria	2.0	-3.5	0.0	1.6
France	0.4	-2.1	0.6	1.7
United Kingdom	0.7	-4.7	-0.3	1.8
Czech Republic	2.6	-3.2	1.2	3.2
Hungary	0.4	-6.0	-1.0	2.0
Poland	4.9	1.0	1.5	3.0
Croatia	2.4	-5.0	0.3	1.5
Bosnia and Herzegovina	5.0	-3.0	0.0	1.0
Serbia	5.4	-4.0	0.3	1.5
Macedonia	5.0	-2.2	0.5	1.5
USA	0.4	-2.8	0.9	3.0
Russia	5.6	-7.0	2.0	3.5

Source: Eurostat; Consensus Forecasts, August 2009; Eastern Europe Consensus Forecasts, August 2009; European Commission, DG Ecfin – Interim Forecast, September 2009; ECB staff macroeconomic projections for the euro area, September 2009; Economist Intelligence Unit Country Reports (for Bosnia, Serbia and Croatia), August 2009, September 2009; OECD Economic Outlook – An Interim Assessment, September 2009; WIIW Current Analysis and Forecasts, July 2009; IMAD's estimates.

The technical oil price assumption anticipates stabilization at the level of USD 75 a barrel in 2010 and a rise to USD 80 a barrel in 2011. The technical assumption for the euro exchange rate is USD 1.427 to EUR 1 and is based on the average euro exchange rate in August 2009.

Table 2.2: Assumptions about the international environment

	2008	2009	2010	2011
USD/EUR exchange rate (annual average) (Euro area and ERM II countries)[1]	1.47	1.38	1.43	1.43
Nominal effective exchange rate[2]	0.5	0.2	0.0	
GDP growth in the EU	0.9	-4.2	0.2	1.6
Growth of relevant export markets[2]	-1.7	-13.7	2.0	6.0
Oil prices (Brent, USD/barrel)	96.9	63.0	75.0	80.0

Source: IMAD, Autumn Forecast 2009. Notes:
[1] Technical assumption based on average exchange rate in August 2009.
[2] Germany, France, Italy, Austria, Hungary, Poland, Czech Republic, Slovakia, United Kingdom, USA.

2.2. Cyclical developments and short-term prospects

As a result of the negative impacts of the international economic and financial crisis, Slovenia's GDP dropped by 7.3% in real terms in 2009, according to our estimate. Given the high integration of Slovenia's economy in international trade flows, the decline in economic activity in 2009 was largely attributable to a significant drop in exports of goods and services, which contracted by nearly 18% in real terms. The drop in foreign orders and gradually also domestic orders was, with diminishing production volumes and lower capacity utilization, also followed by a decline in investment in machinery and equipment. Unfavorable business conditions were aggravated by tougher access to financial resources. Enterprises and non-monetary financial institutions (NFI) posted a very low level of borrowing from domestic banks in the first eleven months of 2009 and the loan potential under the state guarantee scheme for enterprises remained partly untapped due to a lack of appropriate investment projects. With the cyclical slowdown in infrastructure investment, which was even deeper than expected due to difficulties in financing, the volume of gross fixed capital formation dropped by more than a fifth in real terms last year. The level of inventories, which had also dropped notably in the first half of the year, continued to decline in the second, albeit less vigorously, by our estimate, which contributed 2.5 p.p. to the economic activity decline. As households increased precautionary saving and decreased consumption, given the deteriorating situation on the labor market, private consumption is estimated to drop by 2% in real terms in 2009. Amid strong growth in the compensation of employees and fiscal policy measures taken in 2008 and 2009, government consumption is the only consumption aggregate to increase last year (by an estimated 3.2% in real terms).

Assuming that the recession in the international environment will ease, real GDP growth will total 0.9% in Slovenia in 2010. Exports are expected to rise by around 4%, posting a faster recovery in the second part of the year. Private consumption is not yet expected to increase. Assuming almost 1% lower disposable income, particularly due to the wage bill decline and low growth in social transfers along with the anticipated stagnation of entrepreneurial income, households are expected to finance consumption also by drawing on previously accumulated savings. Investment will continue to decline, albeit much more slowly than in 2009. Investment in other buildings and structures will drop. Investors' stocks will have an unfavorable effect on residential investment, with the number of new flats foreseen by the building permits remaining relatively low. Investment in buildings and structures is also expected to decline. On the other hand, after the slump in 2009, investment in machinery and equipment is set to rise somewhat with a gradual increase in capacity utilization this year. Investment will this year also be positively influenced by general government expenditure on investment, particularly investment transfers, while growth of general government expenditure on final consumption will be modest, given the foreseen constraint in general government revenue.

Assuming a global rebound, economic growth is projected to strengthen to 2.5% in 2011, also due to domestic factors. Growth of trade in goods and services will be somewhat higher than this year, with exports still growing faster than imports. The recovery of private consumption will be more gradual. Private consumption, within which the consumption of durables is also expected to resume growth, is expected to increase by 1%. After declining for two years in a row, investment is projected to rise

as well, mainly as a result of investment growth in the private sector, assuming that the situation in the international environment will improve. Residential investment is also expected to gain momentum after two years of intense decline, while infrastructure investment, largely in motorways, will continue to decrease. Government consumption will remain at the level of 2010. Amid stable global economic and financial conditions, economic growth could again exceed 3.5% in 2012.

Risks to the realization of the economic activity forecast remain exceptionally high and are distributed asymmetrically towards lower-than-predicted economic growth, particularly for 2010. The greatest risks are still associated with uncertainty regarding the dimensions of the economic crisis, with additional risks arising from uncertainty about the efficacy of stimulus packages and the possibility of their premature withdrawal. If the recovery in the international environment proves to be slower, Slovenia's GDP will also continue to decline next year, posting lower growth in 2011 than assumed in the baseline scenario.

Table 2.3: Economic growth and related indicators

Change in %	**ESA code**	**Level in 2008**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
		Level in million EUR						
1. Real GDP	B 1 g		3.5	-7.3	0.9	2.5	3.7	3.5
2. Nominal GDP	B 1 g	37,135	7.4	-3.4	1.4	4.6	6.0	5.7
Real GDP components								
3. Private consumption	P3	19,580	2.0	-2.0	0.0	1.0	2.3	2.5
4. Government consumption	P3	6,735	6.2	3.2	-1.5	0.0	2.4	2.5
5. Gross fixed capital formation	P51	10,742	7.7	-21.0	-2.0	3.0	7.0	4.0
6. Changes in inventories and valuables (% of GDP)	P52+ P53	1,201	3.2	0.7	0.9	0.9	0.9	0.8
7. Exports of goods and services	P6	25,134	2.9	-17.9	4.1	6.8	7.5	7.5
8. Imports of goods and services	P7	26,258	2.9	-19.8	1.8	4.9	7.2	6.5
Contributions to real GDP growth (in percentage points)								
9. Final domestic consumption		-	3.6	-9.1	-0.5	1.3	3.4	2.8
10. Changes in inventories and valuables	P52+ P53	-	-0.7	-2.5	0.2	0.0	0.0	0.0
11. Balance of export and import of goods and services	B11		-0.1	1.8	1.4	1.2	0.3	0.7

Source: SORS; Autumn Forecast 2009, IMAD.

The current account deficit narrowed notably last year, mainly due to a lower deficit in merchandise trade, which had even posted a surplus in the first half of 2009 as a result of a faster decline in imports than exports and better terms of trade. This surplus turned into a deficit in the second half of the year, which was expected, mainly due to the seasonal movements and a smaller positive effect of the terms of trade, but the deficit remained much below the level of 2008. The total goods and services trade balance remained highly positive, unlike in 2008, despite a narrower surplus in the services balance, which was mainly due to a lower surplus in trade in

transport services and a higher deficit in trade in other services. The deficit in factor incomes was also lower than a year before. With net external debt remaining approximately at the same level as in 2008 and implicit interest rates on gross external debt falling faster than those on gross external claims in debt instruments, net interest payments to the rest of the world declined. Net outflows of dividends and reinvested profits also fell, according to our estimates. The estimated deficit in current transfers was also lower than a year before. We estimate that the current account will be roughly balanced in 2010 and 2011. With faster volume growth in export than import flows, the merchandise deficit is set to narrow further despite the slight deterioration in terms of trade with regard to the assumed movements of oil and non-oil commodity prices. The surplus in the services balance will increase due to higher net inflows in trade in transport and travel services. On the other hand, net repayment of interest on foreign loans as the main driver of the factor income deficit is expected to increase gradually. The dynamics of the current transfer balance will be more dependent on the net absorption of EU funds. We estimate that Slovenia will maintain its net positive budgetary position against the EU budget in 2010 and 2011.

Table 2.4: Sectoral balances

% of GDP	**ESA code**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Net lending / borrowing	B.9						
of which:							
Balance of imports and exports of goods and services		-3.0	1.8	2.4	3.2	2.9	3.0
Balance of primary income and current transfers		-3.1	-2.2	-2.6	-3.3	-3.5	-3.3
Balance of capital transfers							
Deficit / surplus of the private sector (ESA 95)	B.9/EDP B.9						
Deficit / surplus of the government sector (ESA 95)	B.9	-1.8	-5.7	-5.7	-4.2	-3.1	-1.6
Statistical deviation							

Source: SORS, MoF; Autumn Forecast 2009, IMAD

The **situation on the labor market** also started to deteriorate last year, with an expected lag. Employment is estimated to have declined by 2.4% in 2009. The relatively small overall decline in employment with regard to the strong activity decline is partly attributable to the measures aimed at preserving jobs and a higher participation of unemployed persons in active employment policy programmes, but also to how enterprises responded to the economic slowdown (by reducing overtime work and shortening working hours rather than cutting jobs). The decline in employment was accompanied by growing unemployment. The number of registered unemployed persons exceeded 95,000 in November 2009, which is one half more than a year before. Last year, the average annual registered unemployment rate totaled 9.1% and the survey unemployment rate 5.7%, by our estimate. Employment is expected to decline further in 2010 and 2011. Given the wide gap between declines in economic activity and employment in 2009, the labor market is projected to continue to adjust by cutting jobs, given that economic activity is not set to accelerate strongly yet. We estimate that employment will decline most notably in activities that recorded large value-added drops in 2009, which have not yet

translated into lower employment, as well as in activities where the number of employed persons has already been declining for several years (agriculture, mining and certain manufacturing sectors). The number of employed persons is thus expected to drop by 1.6% in 2010 and by a further 0.9% in 2011. Reflecting these movements of employment, unemployment will also increase further in the following years. The expected increase in the average number of the registered unemployed in 2010 will be largely due to unemployment movements (strong growth) in 2009, which means that the average registered unemployment rate will climb to 10.6%. In 2011, when the subsidy scheme for shorter working hours is set to expire according to the regulations now in force, unemployment is expected to rise somewhat again, to 10.9%.

Table 2.5: Movements on the labor market

	2008 level (in 000)	2008	2009	2010	2011	2012	2013
Employment (number of employees)[1], growth in %	989	2.8	-2.4	-1.6	-0.9	0.7	0.7
ILO unemployment rate, in %	46	4.4	5.7	6.7	7.3	7.2	6.8
Labor productivity (by the number of employees)[2]	38	0.7	-5.0	2.5	3.4	3.0	2.8
Compensation of employees, in EUR mn	18,955	10.1	0.0	0.0	0.6	2.9	2.9
Compensation of employees per employee, in EUR[3]	19,141	7.0	3.6	2.0	1.3	2.2	2.1

Source: SORS, Autumn Forecast 2009, IMAD
Notes: [1] Persons in employment according to national accounts (domestic concept), [2] Real GDP [3] Full-time employees.

Lower economic activity in 2009 was also reflected in the **movement of wages** in the private sector, where the gross wage increase slowed significantly in nominal terms (to 0.8% from 7.8% in 2008, according to our estimate). We estimate that enterprises tried to weather the crisis by streamlining business operations and, despite the measures aimed at preserving jobs, also by laying off employees, particularly lower-skilled workers. The slowdown in the growth of the gross wage per employee was therefore relatively less pronounced than the decline in economic activity. Extraordinary year-end payments were also much lower than in previous years, according to our estimates. As a result of adjustments carried out to eliminate wage disparities, the nominal increase in the gross wage per employee in the public sector was relatively high in the year as a whole (an estimated 7.0%), with the largest part coming from high wage rises in 2008 and the second quarter of funds to eliminate wage disparities disbursed in January 2009. The relationship between wage growth and labor productivity growth thus deteriorated significantly in 2009. Total wage growth exceeded productivity growth measured by GDP per employee by 3.9 p.p. in nominal terms and by 6.9 p.p. in real terms. In the private sector, this gap was smaller (by 1.8 p.p. in nominal and 4.8 p.p. in real terms) than in the public sector, where nominal wage growth was by 8.2 p.p. higher than total labor productivity growth (11.1 p.p. in real terms), according to our estimate.

The Autumn Forecast projects that wage growth will slow in 2010, due to lower growth in the public sector, while wage growth in the private sector is expected to be stronger. As the wage policy for the public sector had not yet been agreed upon when the Autumn Forecast was made, the forecast is based on a restrictive assumption of 1% nominal growth projecting regular public servants' promotions to be the main driver of growth. The forecast for private sector wages (2.4% in nominal terms) takes account of a slight recovery of economic activity and the effect of a higher number of working days and structural shifts in employment to the benefit of highly qualified labor. Amid such movements of public and private sector wages, the growth of the total gross wage (2.1% in nominal and 0.6% in real terms) would lag behind labor productivity growth as measured by GDP per employee (3.1% in nominal and 2.5% in real terms). Furthermore, the Autumn Forecast projects wage rises to be equal in the private and public sectors in 2011 (a nominal 3.9%), lagging 1.6 p.p. behind labor productivity growth. The nominal increase in private sector wages is consistent with a further improvement in the economic environment in a year that will otherwise be three working days shorter than the year before. The autumn forecast for wage rises in the public sector includes promotions and a gradual introduction of wage components that were temporarily abolished within the package of wage policy measures for the public sector (in the field of work performance). The negotiations on public sector wages, which were still underway when the Autumn Forecast was made, were brought to an end in October 2009 with the adoption of a new Agreement on Measures regarding Public Sector Salaries for the Period December 2009–November 2011 and Annex No. 2 to the Collective Agreement for the Public Sector. Public sector wages are therefore estimated to increase more than what was expected in the Autumn Forecast (3.1% in nominal terms), mainly as a result of the third quarter of funds to eliminate wage disparities that will be disbursed in October 2010. Also in 2011, public sector wages will see higher growth (6.0% in nominal terms) than expected in the autumn, largely due to the impact of the disbursement of the third quarter and the expected payment of the fourth quarter of funds to eliminate disparities in October 2011. For these reasons, total wage growth will increase by more than half a percentage point compared with the autumn forecast. Despite considerable public finance impacts, these changes will, by our estimate, have a relatively small influence on total disposable income growth in 2010 and 2011. They are not expected to contribute more than a few tenths of a percentage point to the possible higher growth in private consumption relative to the autumn forecast; this influence might be even smaller, considering the greater risk that the number of the unemployed will increase.

Inflation slowed in 2009. After declining rapidly in the first half of 2009, inflation hovered around zero in the period from August to October, but started to rise again in the last months of the year, totaling 1.8% y-o-y in December. Average inflation dropped to 0.9% (from 5.7% in 2008). In 2009, inflation movements were significantly affected by the decline in economic activity in Slovenia as well as in its trading partners, which resulted in slower growth or even a decline in most groups of the price index. The contribution of higher energy prices to year-end inflation was, however, higher than in 2008. Price rises were also accelerated by increased excise duties (higher excise duties contributed 1.0 p.p. to 1.8% inflation in 2009) and certain prices under various regulation regimes, which soared in the last few months, after changes in the system for setting municipal services prices had taken effect. In view of the expected recovery of economic activity, y-o-y inflation is expected to increase

to 2.0% in 2010 and average inflation to 1.5%. Assuming a gradual global rebound in economic activity, upward pressures on price growth are set to increase somewhat in the entire euro area. Assuming continued modest growth in oil and non-oil commodity prices on global markets accompanying a further pickup in economic activity in the international and domestic environments, y-o-y inflation will rise somewhat further in 2011, to 2.7% by the end of the year, and average inflation to 2.5%. Similar developments are also expected for 2012. Prices of services are expected to rise faster than merchandise prices in these years, thus catching up with the price level in the euro area. The risks that inflation might diverge from what was expected for this period are symmetrically distributed, according to our estimate. The greatest risk for the realization of the central inflation forecast is associated with uncertainty regarding the dynamics of the economic recovery in Slovenia and abroad. Inflationary pressures may also increase due to certain factors arising from the domestic environment, particularly those related to tax policy measures that might be taken by the government.

Table 2.6: Price movements

Change in %	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
1. GDP deflator	3.8	4.2	0.6	2.0	2.2	2.1
2. Consumer price index	5.7	1.0	1.5	2.5	2.7	2.7

Source: SORS; Autumn Forecast 2009, IMAD.

2.3. Medium-term scenario

The projections in the Stability Programme are made using the medium-term scenario of economic trends, which is based on the Autumn Forecasts of Economic Trends and assumptions for the international environment according to the baseline scenario, including economic policy measures that have already been enforced, which is in line with the Guidelines on the Format and Content of Stability and Convergence Programmes. The baseline scenario does not take into account the structural reform measures which are still in preparation.

Considering the assumptions about the international environment in the baseline scenario of the Autumn Forecast and the adopted economic policy measures, economic growth is expected to rise just above 3.5% again after 2012. Annual growth in exports will hover between 7% and 8% in real terms. Private consumption will post almost 2.5% real growth. Investment in infrastructure projects will remain an important factor of economic growth, particularly investment in the modernization of the railway network. Investment will increase by around 5% in real terms. The contribution to economic growth of factors based on investment in knowledge will increase gradually, also on account of the expected higher investment in R&R.

Table 2.7: Key macroeconomic indicators until 2014

Average annual growth rates in %	**Scenario for the 2012–2014 period**
Gross domestic product	3.6
Export of goods and services	7.5
Import of goods and services	6.9
Private consumption	2.4
Government consumption	2.5
Fixed capital formation	5.3
Employment, growth in %	0.7
ILO unemployment rate, in %	6.6
Productivity, growth in %	2.9
Inflation, in %	2.7

Source: IMAD's projections, September 2009.

The forecast of GDP growth was revised downwards significantly compared with the previous Stability Programme, especially for 2009. As a result of the economic and financial crisis, goods and services trade flows and gross fixed capital formation declined much more notably in the first half of 2009 than expected when the previous Stability Programme had been prepared. Private consumption movements were also more negative. Such movements also demanded a lower forecast of total GDP growth for 2009. Due to a relatively stronger drop in imports, the contribution of international trade to economic growth is otherwise somewhat higher in the present than in the previous forecast. The downward revision of economic growth forecast for 2009 is, however, primarily due to a significant lowering of the forecast for gross fixed capital formation related to the credit crunch, deteriorated export results and consequent lower capacity utilization, and a lower forecast for private consumption. In the future, recovery is set to be slow, at a similar level as presented in the previous amendment to the programme.

2.4. Impact of structural reforms on growth

Recovery from the crisis depends critically on external demand recovery and normalization of financial conditions. However, the structural reform agenda aiming at improving potential growth and contributing to long-term sustainability of public finances is a critical component of the strategy of economic recovery from crisis and fiscal consolidation. Fiscal consolidation path priority will be given to reforms that contribute to sustainability of public finances, to those that avoid that the consequences of the crisis become permanent and those that will contribute to the return of the economy to sustainable growth. To this end in 2009 a new “development oriented” program budget classification was introduced that is used for the preparation of the state budget. This new classification better links development programming and public finances and enhances the quality of public finances.

Further institutional changes concerning development planning are to be introduced which will facilitate the design and prioritization of reforms in light of the impact on growth and within the overall budget constraint and fiscal consolidation goal.

Measures aiming at economic recovery, growth and competitiveness include those concerning increase in productivity, labor participation and infrastructure. Among the policies aimed at improving productivity that the government is implementing and will be given priority (see NRP[2]) include: improving business environment and facilitating access to SMEs financing, modernizing tertiary education, fostering investment in research and development and use and diffusion of ICT (information communication technology). Policies towards enhancing labor participation include lowering tax burden on low income earners, enhancing education and skills, active labor market policy and increasing retirement age. Short-term crisis measures that proved to be effective, particularly aimed at avoiding long-term unemployment, will continue to be implemented by reallocating government expenditure from non-priority programs. Concerning infrastructure effort will continue to be devoted to enhancing transport infrastructure, particularly railways, and facilitating the use and deployment of "green" technologies.

The key components of fiscal consolidation effort during the program period and on the long-term are the modernization of the pension system (Chapter 6), rationalization of the health system and better targeting of social transfers (Section 5.2).

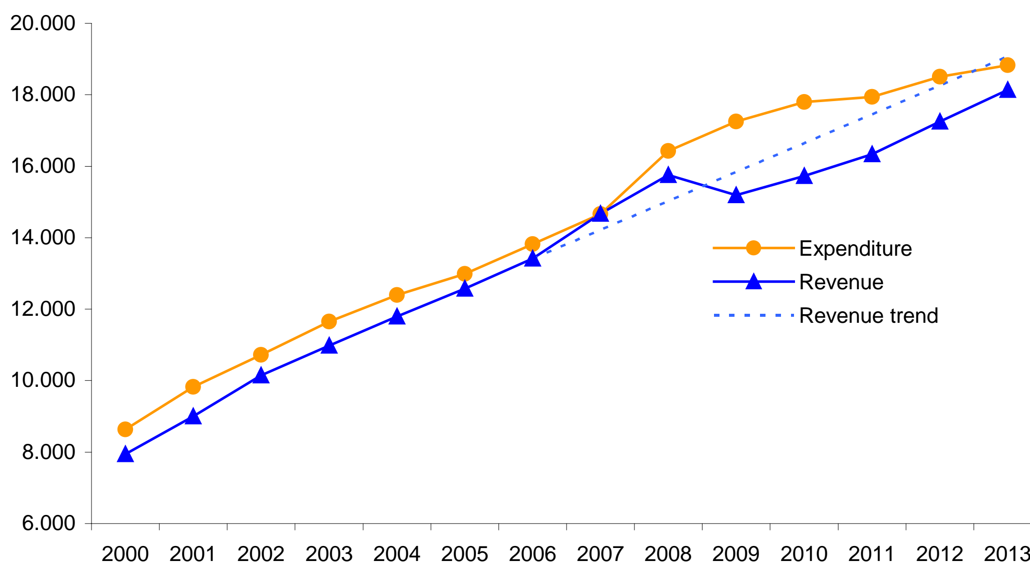
3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1. Policy strategy

The international financial crisis and the collapse of external trade hit the economy in the last quarter of 2008 in the year when fiscal consolidation process on the back of strong economic performance reverted. The government balance changed from a marginal surplus in 2007 to a deficit in 2008 (1.8% of GDP). This was mainly due to: a) delayed implementation of the Law that corrected wage disparities in the public sector; b) granting of additional social transfers and; c) reduction of tax rates and introduction of tax allowances (See SP 2008). As a result of the crisis and policy response the government deficit widened in 2009 to an estimated 5.7% of GDP. The most notorious effect of the drop of economic activity in 2009 and envisaged slow economic recovery in the program period (2009-2013) on the public finances is a downward shift in the government revenue trend level of around 2% of GDP which is not reverted in the program period (Figure 3.1).

[2] http://www.svrez.gov.si/fileadmin/svez.gov.si/pageuploads/docs/lizbonska_strategija/Report_on_Achieving_Lisbon_Strategy_Goals_-_Slovenia_2009.pdf

Figure 3.1.: General government's revenue and expenditure (millions EUR)



Coping with the crisis has required a policy response targeted to financial system and to the real sector taking into account the degree of financial integration to the European Monetary Union, the effectiveness of policy response in a small open economy and the relative low level of government debt at the end of 2008 (22.5% of GDP).

Policy intervention in the financial system was critical in the first quarter of 2009 when liquidity conditions in the international financial market were most acute. Building on full deposit insurance for retail deposits in 2008, treasury deposits were used to mitigate liquidity risk and ensure the flow of lending to the economy. To this end the Slovenian Development Bank (SID) was also recapitalized. This was followed by the government granting guarantees to bank borrowing and implementing schemes to facilitate lending to SMEs and individuals.

Box 1. During 2009 the measures were implemented to various degrees in view of the international financial conditions and domestic requirements. Treasury deposits with banks increased in the first quarter of 2009 at the time when the crisis was most acute to enhance resiliency of the banking system. To facilitate the normal flow of credit to the economy, borrowing guarantees were granted to two commercial banks in the total amount of two billion €. Similarly, guarantees have been extended to banks for sharing the risk of lending to the real sector. In six auctions, the commercial banks were awarded 459 million € of guarantee commitments to lend to enterprises. Until now banks used 184.4 million with which they lent 535 € millions to enterprises. This represents an average government risk sharing in total amount lent by banks of 34.6%. The execution was rather low in the first auctions but has increased since then to more than 80%. Given that Slovenian banking system's exposure to toxic assets (impaired assets) was limited, no intervention measures are envisaged to this purpose. With a gradual normalization of financial market conditions and in line with EU policy the financial intervention measures will be also phased out.

In addition to policies towards easing banking credit to the economy, the policy response to the crisis in the real sector was implemented primarily by means of the automatic stabilizers (financing government expenditure including additional unemployment benefits with lower revenue) and to lower extent by discretionary policy (Table 3.1). As a consequence government consumption in real terms is estimated to have increased by 3.2% in 2009 and contributed to economic activity.

Table 3.1: Discretionary policy measures to mitigate the crisis and effect of the cycle on fiscal policy (in millions of EUR)

A. Discretionary tax revenue measures in 2009 (1+2)	-128
1.Total tax reduction	-383
a. Past changes in tax system with effect in 2009	-332
b. Additional tax unburdening measures introduced in 2009	-50
2. Tax increase to mitigate revenue shortfall	254
3. Shortened deadline for VAT refund (not affecting the deficit in ESA-95 terms)	-100
4. Revenue shortfall due to cycle/crisis	-1,397
B. Discretionary expenditure measure (5+6)	126
5. Labor market	48
6. Potential growth (R&D, SME)	64
7. One-off compensation for socially disadvantaged	14
8. Additional compensations for unemployment due to a crisis (2009/2008)	94
C. Total discretionary policy (A+B)	254
D. Total cyclical component (4+8)	1,491
E. Savings measures in the area of public administration	476
a. Wages	354
b. Goods and services	122
F. Fiscal stimulus not affecting directly the deficit (a+b)	248
a. Recapitalization SID bank	160
b. Recapitalization of the fund for small enterprises	88
Memorandum item	
Net financing from EU	155

Source: MF RS.

Discretionary policy response was limited given: a) the relative effectiveness of such a policy in a small and very open economy; b) in view of previously agreed changes in the tax system that took effect in 2009 that unburdened the economy and; c) the increases in government expenditure (i.e. wages) that had to be curbed in order to limit their impact on the fiscal stance. Total discretionary policy measure influencing the real sector directly (employment and productive capacity) amounted to 254 million EUR.

The government in 2009 made savings in the area of public administration costs and public services. With measures implemented the expenditures for wages were lowered by 354 million and expenditures on goods and services by 122 million

compared to the adopted budget (and were by 25 million lower than in 2008). Effort was placed in withdrawing of EU funds (net surplus of EUR 155 millions) which contrasts with the realization in 2007 and 2008 when Slovenia was a net payer to the EU budget.

Policy measures not affecting directly the deficit amount to EUR 248 million in 2009 (Table 3.1). The government also prefinanced partly the 2010 borrowing requirement and used these proceeds and deposits to enhance liquidity of the banking system.

Looking over the medium term (program period 2010-2013) and under a foreseen weak economic recovery, the key policy challenge is to cope with the shift in government revenue trend and at the same time ensure a fiscal consolidation taking into account the quality aspects of the public finance. On a longer term perspective, given the impact of the crisis on revenue, tackling sustainability of age-related expenditure is of outmost importance. To address these challenges and not withstanding the uncertainty surrounding the economic outlook the government has endorsed a fiscal consolidation strategy based on three components: 1) withdrawal of fiscal stimulus involving measures directly affecting the real sector by the end of 2010; 2) relying on a expenditure-based fiscal consolidation policy to reduce the deficit below 3% by 2013 and; 3) further reforming the pension and health systems to underpin fiscal consolidation and sustainability of public finances.

With regard to the fiscal stimulus, the parliament adopted the 2010 and 2011 budgets in November 2009. The 2011 approved budget does not foresee a prolongation of discretionary measures influencing the 2009-2010 budgets. Labor-related expenditure will be limited mainly to unemployment benefits (automatic stabilizers) which will remain at a relative high level and more than double the level reached in 2008. The relatively successful policy implemented due to the crisis concerning subsidies for R&D expenditure will remain at high level but will be financed by means of reallocating resources of non priority expenditure programs.

The objective of reducing the deficit below 3% of GDP by 2013 will be pursued by a fiscal consolidation based on reducing and rationalizing government expenditure (see section 5.2). The aim is to keep the tax burden at current level while at the same time rationalize the redistributive role of the State and gain efficiency of the public sector. To this end the government will reduce expenditure by 4% of GDP in the period 2009-2013 to a level of 44.2% in 2013. The government revenue level will remain fairly constant and in 2013 will be at the same level as in 2009 (42.5% of GDP). While maintaining revenue constant, two changes are envisaged that modify its structure: Lowering tax burden on low income earners by financing it with increase in excise duties and widening the base for paying contributions to the health system (Section 5.1) The chosen fiscal consolidation strategy should result in a government deficit at the end of the program period below the reference value (1.6% of GDP). Such a level of deficit in 2013 should be consistent with a safety margin sufficient not to breach the reference value under normal cyclical fluctuations.

In view of the envisaged tight fiscal policy, priority of reform will be given to measures not affecting adversely the envisaged fiscal consolidation path. To preserve the quality of the adjustment, additional effort will be given to finance investment with EU funds (Section 5).

3.2. Fiscal consolidation, structural deficit and medium term policy objective

Assessing the fiscal stance on structural basis has become challenging due to the effect of the crisis but also because of volatility of data in small economies. Successive revisions of potential output estimates and as a consequence of output gap estimates can provide quite different picture in real time compared to ex-post estimates. Table 3.2 shows successive potential output estimates for Slovenia in the current and previous two updates of the Stability program. This implies that estimates of structural balance have to be considered carefully as well as policy guided by estimates of potential output in real time.

Table 3.2: Potential growth estimates

in % of GDP	**2008**	**2009**	**2010**	**2011**
1. Potential growth of GDP (SP 2007)	4.3	4.2	4.7	
2. Potential growth of GDP (previous update)	3.2	2.7	2.6	2.5
3. Potential growth of GDP (this update)	3.1	2.2	2.0	2.2
4. Difference (3-1)	-1.2	-2.0	-2.7	
5. Difference (3-2)	-0.1	-0.5	-0.6	-0.3

Source: MF RS.

Taking into account the above mentioned caveats, Table 3.3 shows the structural deficits underpinned by the expenditure-based consolidation strategy. Under the policy aiming at reducing the general government deficit to below 3% of GDP by 2013, the structural deficit will decline from 4.8% of GDP in 2009 to 1% of GDP in 2013. By the end of the program period Slovenia will reach the medium term objective as set in the previous update. The structural balance will be reduced by 1% of GDP on average over the period 2010-2013. This highlights the strong fiscal effort placed during the program period consistent with the aim of long-term sustainability of public finance. The dimension of the reduction of the structural balance is fully consistent with and the dynamics is even more ambitious than the Council recommendation to Slovenia regarding the elimination of the excessive deficit.

Table 3.3: Cyclical developments

	in % of GDP	ESA code	**2009**	**2010**	**2011**	**2012**	**2013**
1.	Real GDP growth (%)		-7.3	0.9	2.5	3.7	3.5
2.	Net lending of general government	EDP B.9	-5.7	-5.7	-4.2	-3.1	-1.6
3.	Interest expenditure	EDP.41	1.2	1.8	1.8	2.0	2.1
4.	One-off and other temporary measures						
5.	Potential GDP growth (%)		2.2	2.0	2.2	2.2	2.3
	contributions:						
	- labor		0.1	0.3	0.1	-0.2	-0.4
	- capital		1.4	1.3	1.3	1.4	1.4
	- total factor productivity		0.7	0.4	0.8	1.0	1.2
6.	Output gap		-3.3	-4.3	-4.0	-2.5	-1.3
7.	Cyclical budgetary component		-0.9	-1.5	-1.4	-1.0	-0.7
8.	Cyclically-adjusted balance (2 - 7)		-4.8	-4.2	-2.8	-2.1	-1.0
9.	Real GDP growth (%)		0.0	0.6	1.4	0.6	1.2

Source: MF RS.

When looking at the drivers of growth based on production function estimates these indicate that it will be underpinned by capital accumulation and gradual increase in total factor productivity. The average potential growth rate in 2009-2013 is estimated at 2.2% compared to 3.5% for the period 2003-2008. In both periods growth is explained predominantly by capital accumulation but this is lower in the program period. In the period 2003-2008 labor contribution to growth was positive. In the program period a negative contribution of labor to growth is estimated. This was also the case in the estimates of production function presented in the previous update of the Stability Program highlighting on the one hand the degree of relative flexibility of the labor market and the challenge ahead to create jobs.

3.3. Actual balances and implications

According to revised data the general government deficit in 2008 was 1.8% of GDP and not 0.9% of GDP as stated in the previous update. The main reasons explaining the difference is higher tax returns on 2008 corporate income tax paid back in the month of April 2009 and unexpectedly high deficit at the level of local governments (0.6% of GDP).

The deficit in 2009 widened to an estimated 5.7% of GDP (Table 3.4). This is the result of the effect of the crisis on both revenue and expenditure (automatic stabilizers) but also due to discretionary fiscal policy. Total government revenue growth was negative (5.7%) comparing to positive growth rates above 7% on average in the previous years. Expenditures increased mainly due to subsidies and transfers and still strong wage dynamics from the previous years.

With a weak economic recovery and still implementing fiscal stimulus measures in 2010 the government balance is expected to remain at the same level as in 2009 (5.7%). Revenue is expected to increase particularly because of the recovery in VAT and increase in excise duties. Expenditure growth will further decline in 2010; despite this fact the expenditure-share in GDP will the peak in the program period.

In 2011 the deficit will be sharply reduced to 4.2% of GDP due to the withdrawal of fiscal stimulus and the relative high level of EU financing of investment. The expenditure growth will be only 0.8% but social transfers will be still importantly contributing to it. Revenue growth will remain low from 2011 onwards (close to 5% on average) as the crisis will still affect profits but to a lesser extent personal income tax.

The deficit in 2012 is expected to further fall to 3.1% of GDP on the back of expenditure policies pursued by the government. In 2013 the deficit will be 1.6% of GDP, well below the reference value and the excessive deficit will be corrected. Such a level of deficit caters for an appropriate safety margin against a breach in the deficit ceiling. Looking beyond 2013 the intention is to consolidate further towards a balanced budget.

The deficit dynamics in the period 2009-2013 is heavily imprinted by the fall in the revenue trend. Another important feature will be the increase in interest expenditure which will almost double to 2% of GDP by the end of the program period. The

consolidation policy will be underpinned by further reform of the pension system which contributes to long term sustainability of public finances.

The balances of the various sectors, composing the general government sector, during the program period indicate that the bulk of the deficit is at the level of the central government. The historically high deficit level of local governments in 2008 (0.6% of GDP) is estimated to have been reduced to 0.4% in 2009 and will gradually decline to 0.1% of GDP in 2013. The health fund balance changed from being in equilibrium in 2008 to a deficit in 2009 (0.2% of GDP). The deficit level is expected to practically disappear by the of the program period.

Table 3.4: General government budgetary prospects

	ESA Code	2008 Level	2008	2009 estimates	2010	2011	2012	2013
		mio EUR	% GDP	% GDP	% GDP	% GDP	% GDP	% GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	**-667.3**	**-1.8**	**-5.7**	**-5.7**	**-4.2**	**-3.1**	**-1.6**
2. Central government	S.1311	**-460.9**	**-1.2**	**-5.1**	**-5.1**	**-3.8**	**-2.8**	**-1.4**
3. State government	S.1312							
4. Local government	S.1313	**-212.8**	**-0.6**	**-0.4**	**-0.4**	**-0.3**	**-0.2**	**-0.1**
5. Social security funds	S.1314	**6.3**	**0.0**	**-0.2**	**-0.2**	**-0.1**	**-0.1**	**-0.1**
General government (S.13)								
6. Total revenue	TR	**15,756.2**	**42.4**	**42.4**	**43.2**	**42.9**	**42.7**	**42.5**
7. Total expenditure	TE	**16,423.5**	**44.2**	**48.1**	**48.9**	**47.1**	**45.9**	**44.2**
8. Net lending / borrowing	EDP B.9	**-667.3**	**-1.8**	**-5.7**	**-5.7**	**-4.2**	**-3.1**	**-1.6**
9. Interest expenditure	EDP D.41	**411.3**	**1.1**	**1.2**	**1.8**	**1.8**	**2.0**	**2.1**
10. Primary balance		**-256.0**	**-0.7**	**-4.6**	**-3.9**	**-2.3**	**-1.1**	**0.4**
11. One off expenditures								
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		**8,534.5**	**23.0**	**22.4**	**23.1**	**23.0**	**22.9**	**22.8**
12a. Taxes on production and imports	D.2	5,162.6	13.9	13.6	14.3	14.2	14.0	13.8
12b. Current taxes on income, wealth, etc	D.5	3,360.9	9.1	8.8	8.8	8.7	8.9	9.0
12c. Capital taxes	D.91	11.0	0,0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	**5,311.4**	**14.3**	**15.0**	**14.9**	**15.0**	**14.9**	**14.9**
14. Property income	D.4	**306.8**	**0.8**	**0.5**	**0.5**	**0.4**	**0.4**	**0.4**
15. Other		**1,603.4**	**4.3**	**4.4**	**4.6**	**4.6**	**4.5**	**4.5**
16. Total revenue	TR	**15,756.2**	**42.4**	**42.4**	**43.2**	**42.9**	**42.7**	**42.5**
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		**13,846.0**	**37.3**	**37.5**	**38.0**	**38.0**	**37.8**	**37.7**

Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	**6,350.4**	**17.1**	**18.7**	**18.7**	**17.9**	**17.2**	**16.5**
17a. Compensation of employees	D.1	4,111.5	11.1	12.5	12.4	11.8	11.4	11.0
17b. Intermediate consumption	P.2	2,238.9	6.0	6.2	6.3	6.0	5.7	5.5
18. Social payments (18=18a+18b)		**6,192.0**	**16.7**	**18.6**	**19.1**	**18.9**	**18.4**	**18.2**
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D. 63131	719.8	1.9	2.3	2.3	2.3	2.2	2.1
18b. Social transfers other than in kind	D.62	5,472.2	14.7	16.2	16.7	16.6	16.3	16.0
19. Interest expenditure	D.41	**411.3**	**1.1**	**1.2**	**1.8**	**1.8**	**2.0**	**2.1**
20. Subsidies	D.3	**606.3**	**1.6**	**2.1**	**2.2**	**1.8**	**1.8**	**1.3**
21. Gross fixed capital formation	P.51	**1,603.8**	**4.3**	**4.4**	**4.6**	**4.2**	**4.0**	**3.8**
22. Other		**1,259.8**	**3.4**	**3.2**	**2.6**	**2.5**	**2.4**	**2.2**
23. Total expenditure	TE	**16,423.5**	**44.2**	**48.1**	**48.9**	**47.1**	**45.9**	**44.2**

Source: MF RS.

3.4. Debt levels and developments

The outstanding amount of general government consolidated debt is estimated at 12,331 mio EUR (34.4% of GDP) at the end of 2009. The largest share (90%) of the total represents the State Budget's debt which has a relatively sound structure[3]. After the sharp increase in debt in 2009 due to a high deficit and pre-financing of the 2010 borrowing requirement, the proceeds of which were used to enhance liquidity conditions of the banking system, the debt level is going to follow a decreasing trend in the size of deficits during the period 2010-2013. To enable the Treasury to borrow beyond the size of deficit and lending minus repayment operations in 2009 a change was introduced to the Law on Public finance allowing the Treasury to borrow in advance up to the amount of principal debt maturing in the next budget year.

The debt-to-GDP ratio increased substantially in 2009. After a further additional sizable increase in 2010 the debt ratio is going to stabilize around 42% of GDP on average in the period 2011-1013. The debt dynamics will be driven primarily by the central government. Local government debt is expected to increase from the level reached in 2009 (1.2% GDP) to a level of 1.7% of GDP by the end of 2013. 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[4].

The increase in general government debt-to-GDP ratio will be explained primarily by primary deficits over the period 2010-2012 (negative primary balances). In 2013 the primary balance will turn to surplus position. The effect of the difference between interest and GDP growth in debt dynamics (the so called "Snow-ball effect") is relatively high in 2009 and 2010 due negative economic growth in 2009 and weak economic recovery. This factor becomes practically irrelevant from 2011 onwards as the economic recovery strengthens. The size of the stock-flow adjustment turns from sizable in 2009 (5.4% of GDP), reflecting pre-financing of the 2010 borrowing requirement and increase in Treasury deposits at the banking system, to negligible in the period 2010-2013, as the debt is expected to increase only following the deficit dynamics.

It is important to highlight that the above mentioned dynamics of the debt-to-GDP ratio does not include the envisaged use of privatization proceeds to reduce the debt arising from the forthcoming reorganization of the Capital Fund (KAD) pertaining its

[3] The average weighted years to maturity of central government budget debt was 5.7 years as of 31.12.2009 and will slightly increase in the next years.

[4] 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 20% does not apply.

investment profile from strategic investor to portfolio investor. By using the privatization proceeds the General government debt is envisaged to decline.

Table 3.5: General government debt developments

% of GDP	**2009**	**2010**	**2011**	**2012**	**2013**
1. Gross debt	34.4	39.6	42.0	42.7	42.1
2. Change in gross debt ratio	11.9	5.2	2.5	0.7	-0.7
Contributions to change in gross debt ratio					
3. Primary balance	4.6	3.9	2.3	1.1	-0.4
4. "Snowball effect"	1.9	1.3	0.1	-0.3	-0.2
5. Stock-flow adjustment	5.4	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt	5.0%	5.2%	4.9%	5.1%	5.1%

Source: MF RS.

As part of the process of monetary integration, 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 established which includes 3 resident and 6 non resident banks. Newly issued bonds now trade on major international trading platforms.[5] 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[6], 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. This was followed with an additional successful benchmark EUR 1 bn issue in 2008. 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.

In 2009 the structure of primary dealers changed as the number of nonresident banks increased to nine. Due to larger amount of borrowing requirements, the number of issues increased to 3 in 2009. With the second issue of the new

[5] In 2007 the link between local CSD and two pan-European CSD's (Clearstream and Euroclear) was established.
[6] In 2007 buybacks were executed in the amount of EUR 0.7 billion, and 0.1 billion in 2008, while there were no buybacks executed in 2009, due to low interest of the holders of government bonds.

government bond the benchmark increased from 1 to 1.5 bn EUR, which enhanced the liquidity of the secondary market for government bonds.

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. Nevertheless, with the uncertain economic recovery the policy scenario is subject to downside risks. Major risks affect employment, drivers of economic activity and changes in financing conditions.

Due to Slovenia's high dependency on exports and its integration in international financial and economic flows the sustainability of the recovery of the Slovenian economy will depend mostly 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 of the strength of the global recovery still indicate a high degree of uncertainty. Forecast estimate a lower growth rates in the future. The risks to the realization of the Autumn Forecast of Economic Growth in Slovenia for 2010–2013 are still extremely high and unevenly distributed in the direction of lower than forecasted economic growth, particularly in 2010. In case of slower global economic recovery, the decrease of GDP in Slovenia would continue in 2010 and increase in 2011 would be lower than assumed in 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 fiscal 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, inflation and real growth of private and government consumption on fiscal balance was assessed.

The risk of underlying macroeconomic scenario on key government revenue components and the fiscal stance is shown in Table 4.1. Assessed risks underlying the current macroeconomic environment include: i) lower real growth rate of average wages; ii) low employment (keeping employment in the economy at the same level as in the previous year); iii) lower real growth of GDP than in previous year; 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. The changes are made taking as a base for comparison the year 2009. 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. Fostering confidence as part of the economic policy is very important 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	-0.10
	Employment	Lower by 1 percentage point	-0.05
	Inflation	Lower by 1 percentage point	-0.10
	Last year's inflation	Higher by 1 percentage point	-0.05
Social security contributions	Real growth in average gross wage	Lower by 1 percentage point	-0.14
	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	-0.04
	Last year's inflation	Lower by 1 percentage point	-0.06
Indirect Taxes	Real growth in private consumption	Lower by 1 percentage point	-0.5
	Real growth in government consumption	Lower by 1 percentage point	-0.02
	Inflation	Lower by 1 percentage point	-0.01

Source: MF RS.

Table 4.2 shows how changes in single macroeconomic variables affect various revenue aggregates as well as the government balance. The impact is most pronounced and similar in the case of inflation and real wage growth. A 1 p.p. increase in inflation would lead to 0.25% of GDP lower revenue. Lower real growth of wages will also result in a decline in revenue of 0.24% of GDP. A decline of employment also affects significantly the fiscal stance in a similar magnitude. Thus a

lower employment and real wage growth will result in a lower revenue and higher expenditure both changes affecting adversely the fiscal stance. This highlights the importance and the well targeted focus of the fiscal stimulus measure towards preserving employment. Taking into account the risks surrounding the economic recovery it was also appropriate in the policy response package to limit additional downward discretionary tax changes or providing additional tax allowances. The simulation also suggests that given the enormous shock to government revenues in 2009 and the negative impact on the revenue trend additional reductions in tax rates or social security contribution rates would have hindered significantly the fiscal stance. A better approach seems to have been the one chosen focus on subsidies and increase in social transfers which can be removed more easily and indeed are going to be removed as part of the withdrawal of the fiscal stimulus in 2010.

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

Macroeconomic base	Change in macroeconomic base	Revenue 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	**-0.24**
Employment	Lower by 1 percentage point	Personal Income Tax, Social Security Contributions	**-0.19**
Inflation	Lower by 1 percentage point	All	**-0.25**
Last year's inflation	Lower by 1 percentage point	Personal Income Tax, Corporate Income Tax	**-0.11**
GDP growth in t-1	Lower by 1 percentage point	Corporate Income Tax	**-0.04**
Real growth in private consumption	Lower by 1 percentage point	Indirect Taxes	**-0.5**
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 in 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 to 99.5% in 2011.

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 5.7 years at the end of 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 0.079% in the year 2011, 0.074% in the year 2012 and 0.07 in the year 2013. In this case the state budget debt would increase by 0.223% of GDP in 2012 and 0.422 % of GDP in 2013. In the case that the deficit of the government would increase by 1 p.p. the interest cost as percentage of GDP would increase by 0.053% in 2011, 0.05% in 2012 and 0.047% in 2013.

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
2010	0.000%	0.000%	0.000%	1.000%	0.000%	1.000%
2011	0.079%	0.079%	0.053%	0.598%	0.145%	0.743%
2012	0.074%	0.223%	0.050%	0.227%	0.136%	0.636%
2013	0.070%	0.422%	0.047%	-0.104%	0.129%	0.670%

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. Notwithstanding, the relative insensitivity to changes in financial variables, the crisis has affected significantly the debt dynamics and debt service reflected in a strong increase in debt in 2009 and increase in interest expenditure over the medium term which at the end of the program period doubles the level reach in 2008 (Table 3.4)

4.4. Comparison with the 2008 Stability Programme

Estimated GDP growth compared with the previous update, particularly for 2009, is strongly corrected downwards. In the first half of 2009, the decline in flow of goods and services and fixed capital formation, due to the impact of the economic and financial crisis, is considerably higher than anticipated in the previous update; private consumption was lower than anticipated as well. Such trends lie behind lower GDP growth forecast for 2009. The contribution of foreign trade to economic growth is, due to the relatively stronger decline of imports in the present forecast, somewhat higher than in the previous one. However, the sharp reduction in forecast of fixed capital formation, related to the credit crunch and weak export performance resulting in a lower utilization of production capacity, and lower forecast of private consumption, are the key contributions to the reduction of the economic growth forecast for 2009. Looking forward a slow recovery is foreseen, which is similar to the one depicted in the previous update.

The general government deficits for the period 2009-2011 are higher than those presented in the previous update due to: i) stronger fall in economic activity than

envisaged (Table 4.4); ii) operation of automatic stabilizers on the revenue and expenditure side; and iii) different dynamic of implementation of discretionary policy measures.

On the debt side the difference concerns higher deficit in 2008 than envisaged (1.8% of GDP and not 0.9% of GDP) and pre-financing of the 2010 borrowing requirement the proceeds of which were used to enhance the liquidity of the financial system in the first quarter of 2009 at the time where the financial crisis was most strongly felt.

Table 4.4: Divergence from previous update (April 2009)

% of GDP	2008	2009	2010	2011	2012	2013
1. Real GDP growth						
Stability program (previous update)	3.5	- 4.0	1.0	2.7		
Stability program (latest update)	3.5	-7.3	0.9	2.5	3.7	3.5
Difference	0.0	-3.3	-0.1	-0.2		
2. General government net lending						
Stability program (previous update)	-0.9	-5.1	-3.9	-3.4		
Stability program (latest update)	-1.8	-5.7	-5.7	-4.2	-3.1	-1.6
Difference	-0.9	-0.6	-1.8	-1.2		
3. General government gross debt						
Stability program (previous update)	22.8	30.5	34.1	36.3		
Stability program (latest update)	22.5	34.4	39.6	42.0	42.7	42.1
Difference	-0.3	3.9	5.5	5.7		

Source: IMAD, SORS, MF RS.

5. QUALITY OF PUBLIC FINANCES

The quality aspects of the public finance in Slovenia have to be looked in a time perspective covering the period before the crisis, the response to the crisis in the years 2009-2010 and in the future including the program period and beyond.

Before the crisis important changes in the tax system were introduced with the reform of 2006-2007 whose implementation and effects are still unfolding. For example the corporate income tax rate has been further decreased in 2010 as a result of the adopted measures in the past (see section 5.1). Such a reform enhanced incentives for labor as well as for capital but its financing was not accompanied by ensuring revenue neutrality or reduction of expenditures. The latter in fact substantially increased in 2008 on the back of an increase in wages and social transfers. To some extent the increase in wages responded to an unsustainable wage policy carried out in the period 2002-2007 which created contingent liabilities on wage rights (a law to correct wage disparities in the public sector).

With the crisis the weakness of the tax reform financing became clear particularly because the tax reform was not neutral but the government revenues decreased. At the same time the government expenditure did not decrease. The crisis has resulted in a downward shift in government revenue trend that, in absence of an increase in taxes, is not corrected in the near future. In light of the difficulties of reducing fast the

expenditures (which even increased) the crisis poses an important challenge to public finances and the objectives that have been pursued over the past years.

While past tax policy changes implemented in 2009 operate as fiscal stimulus (Table 3.1), given the dimension of the revenue shortfall the full operation of the automatic stabilizers had to be limited by the government through an increase in excise duties amounting to 0.7% of GDP and by restraining wage policy. To some extent, the increase in indirect taxes partially financed the effect of the past tax reform.

It is within the unfolding past policy changes that the fiscal policy response to the crisis has to be understood but also taking into account the effectiveness of discretionary policy in a small and open economy. The fiscal stimulus affecting directly the real economy by means of tax and expenditure policy followed the broad economic policy orientation agreed among EU countries of being targeted and temporary. Discretionary expenditure policy implemented in 2009 and 2010 pursues the objective of limiting the impact on employment and enhancing growth potential by means of subsidies for shortening hours worked and partial unemployment and subsidies for R&D activity. Additional changes in the tax policy were targeted at enhancing liquidity of firms (shorter deadline for VAT refund) and targeted tax relief for sole proprietors. The relative effectiveness of subsidies on labor can be seen in terms of the jobs preserved and in the case of R&D only over the medium term and should be supplemented by reallocating expenditures from inefficient programs to development oriented programs (see Section 5.2). In accordance with the EU agreement the fiscal stimulus is withdrawn by the end of 2010. The economic policy measures in the labor market ahead and within expenditure policy targets will contribute to avoid that those temporary unemployed become unemployed permanently.

The main policy dilemma the crisis has brought forward has been how to ensure the stability of public finances and thus keeping the borrowing cost for the state and the economy in line with the current creditworthiness of the State. This implied to give consideration to: how to mitigate distortions to the economy and public finances; determining what aspects of the social system to rationalize; how to reduce the effects of the fiscal adjustment on various sectors; and determining what structural reforms to be financed from the budget. To this purpose the government has endorsed a strategy that would pursue fiscal consolidation based on expenditure reduction and rationalization (Section 5.2). The tax burden in the economy will be kept constant during the program period to facilitate economic recovery (Section 5.1). To underpin the quality aspects of the adjustment, a reorientation of expenditure will be directed towards development priorities and further effort will be placed in substituting the financing of expenditure from domestic sources to EU funds. Structural reforms will be financed within the agreed fiscal consolidation path. Based on positive developments in net withdrawal of EU funds in 2009, such policy will be stepped up during the program period. Despite the increase in interest expenditure, the level of investment financed from domestic and EU funds will remain high (Section 5.2).

The fiscal consolidation strategy will be underpinned by means of enhancing the long-term sustainability of public finances including further reform to the pension system and healthcare system.

5.1. General government revenues policy

Meeting the overarching fiscal target of lowering the deficit below 3% of GDP by 2013 by relying on expenditure consolidation constrains severely the possibilities of lowering the level of revenue from taxes below that prevailing in 2008 (23% of GDP). It also limits the room to carry out any reduction in the overall level of social security contributions. Thus the strategy concerning tax revenue and social security contributions will be to keep its level as percentage of GDP constant during the program period. This will create stability, certainty and predictability contributing to the economic recovery. The envisaged policy takes place on the background of a past decade of intense changes in the tax system. This includes approved changes in the tax system in 2006 and 2009 also affecting tax revenue dynamics (such as the further reduction of corporate income tax rates in 2010 to 20%). Nevertheless, certain possible systemic changes in tax legislation are being examined with aim of contributing to the stability of public finances and to underpin environmental policy targets.

Notwithstanding, the overall floor on the tax revenue level and the relative high level of indirect taxes comparing to neighboring countries low income earners will be further unburdened in 2010. This reform will be financed by increasing excise duties on tobacco and gas oil used for heating purposes. An additional change, which will increase the tax burden to some extent, concerns the broadening of the tax base for social security contributions for health to other types of income from labor (from contractual arrangements, student work, etc.) which are currently not included in the taxable base. In view of the fiscal consolidation objective a reduction of tax burden, particularly on middle income earners, will be pursued. Nevertheless, as it is explained in section 5.2, the possibilities for further compressing expenditure below the proposed path are slim. It is important to highlight that the reform changes introduced in the past concerning payroll tax, corporate income tax and personal income tax have delivered a more competitive system underpinning Lisbon objectives.

Changes in the tax system affecting the tax revenue dynamics in the program period can be classified in those already approved in the past (2006-2009) and taking effect at the start of 2010; tax changes to be introduced underpinning Lisbon objectives on labor and environment and, systemic changes enhancing fiscal stability and effectiveness of administration of the system.

The effects of the approved changes in the tax system taking place in 2010 include corporate income tax and value added tax. On corporate income taxation, a new tax rate of 20% was introduced in 2010, which has been put in force with the reform of this tax in 2006 (in implementation since 1 January 2007). This further reduction in the tax rate should contribute to economic recovery and can be considered as part of the fiscal stimulus in 2010. The tax rate has been reduced from 25% in 2006 to 20% in 2010. The reform including lower tax rates and incentives for R&D activity renders the system more competitive taking into account internationally enforced tax rate on corporate income.

In the area of VAT, transposition of European Directives into national law was made by amending the Law on Value Added Tax, which became applicable in 2010,

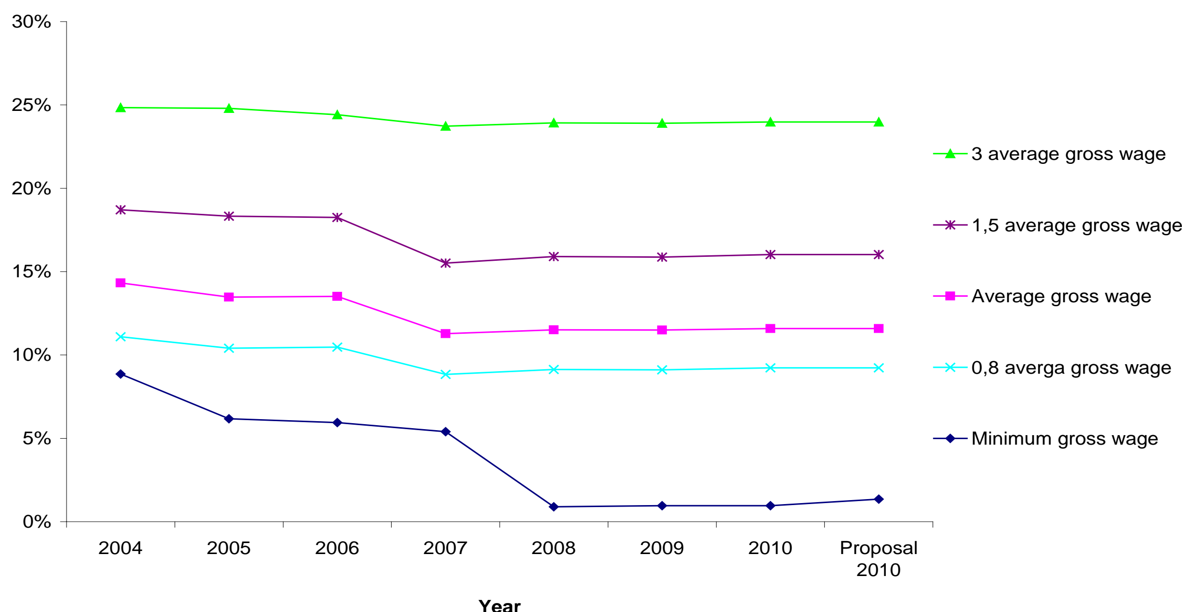
namely: in the area of detailed rules for the refund of VAT to taxable persons, residents of another Member State; new rules concerning the supply of services, in part that had to be enforced by 1 January 2010; new shorter time limits for sending reports to recapitulative intra-Community transactions from three months to one month were introduced; reduced rate of VAT was introduced for certain services provided at the local level and the supply of books on all physical media. Amendments to the Law on Value Added Tax were also required to mitigate the negative effects of the financial crisis and prevent the emergence of new ones. The flat-rate compensation to farmers increased from 4% to 8% and raised the threshold for the use of settled payments from 208,000 EUR to 400,000 EUR. Measures to prevent VAT fraud and ensure competitive conditions to economic entities, were introduced. These amendments are expected to have additional financial effects, particularly measures to prevent organized tax evasion type "carousel fraud", and measures to improve the efficiency of fiscal control. This could serve as an indirect increase in revenue flow to the state budget due to the effect of reduced future tax losses from organized VAT evasion. In this sense, we can talk about the financial impact of the changes made only in terms of identified and additionally accrued tax liabilities in the process of fiscal control, as the VAT evasion is estimated to more than 100 million EUR per year.

Tax changes to be introduced to underpin Lisbon policy objectives concern necessary changes in environmental taxes and further unburdening of the low income earners under the personal income tax regime financed with an increase in excise duties.

Changes in personal income tax system in the past were aimed to enhance incentives to work for low income earners by increasing tax allowances and unburdening qualified workers by introducing a dual tax system with different tax rates applied to labor and capital income. In order to further enhance labor incentives for low income earners, an additional unburdening will be granted in 2010. The Draft Law on personal income tax provides additional general tax allowance for taxpayers with total incomes of up to the first threshold of the total income that would allow enforcement of additional general tax relief. The assumption is that the nominal minimum wage in Slovenia would increase to 562 EUR per month and that the general tax allowance and additional general tax relief for the first threshold would total 510 EUR per month. Further to the additional general tax allowance for lowest income taxpayers, both thresholds for additional general tax reliefs will increase. Taking these measures into account, revenue from personal income tax would be reduced by about 46 million EUR in 2010.

Figure 5.1 shows the effects of past and envisaged future changes to personal income tax burden from wages. It indicates that the tax burden for low wages earners is already relatively low. The distribution of tax burden also highlights future challenges for the tax system reform as the share of personal income tax in GDP after a decade of changes has and will remain fairly constant at the level of 5.9% of GDP until the end of the program period. Meanwhile the tax burden on wages has shifted markedly towards the average wages earners as this segment has limited income from capital. In fact income from capital becomes an important source of total income when total income reaches the level of twice the average wage.

Figure 5.1: Share of personal income tax from wages in gross wages



Source: MF RS.

To mitigate the impact of changes in the personal income on tax revenue, the excise duties will increase. Amendments to the law on excise duties, due to be adopted by 1 April 2010, will transpose the new EU directive to the national legislation, which will enable the enforcement of a new electronic system of control of the movement of products subject to excise duties. Financial effect on the state budget will be indirect and only positive due to the improvement of control. Due to the envisaged amendments of the EU laws on further increase in excise duties on cigarettes, excise duties on cigarettes in Slovenia will increase, with the total amount of increase in revenue in the period 2010-2013 being estimated at around 80 million EUR.

Increase in the excise duties on electricity for business purposes is envisaged with an estimated financial effect of 3.5 million EUR. With the same purpose increase in excise duties on gas oil for the heating purposes is envisaged for 2011 with the financial effect on the revenue of 4.8 million on the annual level.

Regarding environmental tax particularly changes that will contribute to curve excessive burdening of the environment with CO_2 and other harmful environmental emissions (green tax reform) will be examined. In this regard amendments to the law on motor vehicle tax enforce instruments to limit possible tax evasions in this area and introduce environmental criteria for determining the level of tax liability by establishing the tax rate dependent on CO_2 and other harmful emissions by private motor vehicles.

Other changes concern improvement in existing legislation including the property tax (implementation planned for 2011) and amendments to the law on tax procedure (effective since 1 January 2010). The law on property tax will replace two existing levies, namely the charge for the use of building land and property tax. Main changes are better integrated taxation of property through a unified real estate registry within the Surveying and Mapping Authority and determination of tax base on the basis of

general market value, established through the system of mass property evaluation. This change in the system is planned to be financially neutral or marginally positive as the revenue from this levies, currently exclusive revenues of local communities, would increase due to better integration of real estate into taxation.

The amendment to the Law on tax procedure gives a legal basis to enable a more efficient collection of levies. These include amendments on the basis of the implementation of the law so far and amendments due to amendments to European regulations concerning the exchange of information and assistance in recovery.

Other important systemic changes pertain the modernization of the tax information system and simplification of payment of compulsory charges. Over the course of a three-year period a comprehensive modernization of the information system is foreseen with the following expected results:

- increase in tax revenue due to effective tax foreclosure;
- increase in tax revenue due to more effective implementation of fiscal control of tax returns with the tax authorities (desk audit);
- increase in tax revenue due to higher quality selection of taxpayers for inspection with more modern computer tools such as "Data Mining";
- increase in tax revenue due to the rise of voluntary payment of taxes. Effective integrated tax information system is to play a strong preventive role in the behavior of taxpayers.

5.2. General government expenditure policy

The fiscal consolidation strategy is based on gradual government expenditure reduction, their rationalization and replacing financing of certain programs and projects with EU funds were possible. The expenditure consolidation path has been chosen to lower the deficit below 3% of GDP by 2013. This implies a strenuous fiscal effort as the nominal growth of expenditure will be lower than growth on nominal potential output and GDP in the period 2011-2013 (Table 5.1). Already the 2010 approved state budget envisages a reduction in expenditure growth, such as the deferral of wage increases in the public sector and effects of intervention legislation on indexation of social transfers and pensions, despite the fact that fiscal stimulus measures are still included. The fiscal consolidation will take hold firmly from 2011 onwards when nominal expenditure growth will be lower than potential output growth as estimated in this update of the Stability Program (Table 5.1). As a consequence of the envisaged policy the government expenditure-to-GDP ratio after reaching its peak in 2010 (48.9%) will decline by 4.6 percentage points in the program period to 44.2% in 2013.

Table 5.1: Nominal growth of General Government expenditure, potential output and GDP (%)

%	2009	2010	2011	2012	2013
Government expenditure	5.1	3.1	0.8	3.2	1.7
Potential output	6.5	2.6	4.2	4.4	4.4
GDP	-3.4	1.4	4.6	6.0	5.7

Source: MF RS.

The consolidation policy is built on the gradual withdrawal of the fiscal stimulus in 2010. Subsidies to short-time work, part-time unemployment measures, special benefits to socially disadvantaged and measures of small value schemes will be phased out. Subsidies to R&D activities, increased in 2009 and 2010, that contribute to bolster long-term technological development and productivity growth, will be maintained at high level. However, from 2011 onwards they will not be financed by increasing expenditure but by reallocating funds to this end from other programs and within the budget constraint. To avoid that temporary unemployed become long-term unemployed and facilitate the employability of those with less skills, a program aimed at providing job in public works and training will be strengthened as part of active labor market policy. The financing of such a program will be ensured through expenditure reallocation. In particular, the total amount of expenditure on subsidies will slightly decline in nominal terms during the program period (Table 3.4). This in part will be facilitated by transforming the way funds are granted to enterprises from subsidies to refundable funds mediated by the Slovene Enterprise Fund.

The government will follow four objectives: 1) enhancing the efficiency of public sector administration; 2) rationalization of services provided; 3) rationalizing the distributive role of the State and; 4) reorienting expenditure towards development oriented programs including maintaining high investment levels financed by replacing domestic sources with EU funds. These objectives will be underpinned by concrete policy actions which are currently underway.

Policies concerning the efficiency improvement in the public sector relate to the wage bill and to intermediate consumption. The target is to gradually reduce this type of expenditure by 14% during the program period. The program builds on the policy followed in 2009 and already incorporated in the 2010 and 2011 approved budgets. This consists of minimizing the impact of the increase in wages due to the Law correcting wage disparities by reducing the amount of wage adjustment (valorization). Regular performance bonuses, the variable part of wages, are no longer paid since 2009 and this will continue to be the case until 2011. The amount of performance bonus related to workload has been limited. The government also continues to follow the target of reducing the number of employees in public sector by 1% per year in 2010 and 2011. At the end of 2011 the wage disparities will be corrected and reorganization of the public administration should begin resulting in lowering expenditure for wages as well as the number of employees both in the narrow public administration and the public sector. As a result of this policy the total wage bill will increase on yearly average in the period 2009-2013 by only 1.2% and its share in GDP will decline by 1.5 p.p. in four years.

Government's intermediate consumption (predominantly expenditures on goods and services) will be further rationalized by introducing a unified system of public procurement and rationalization of purchases of goods and services. As a result of this policy the resources devoted to intermediate consumption during the program period will remain fairly at the level reached in 2009 in nominal terms.

The second set of measures concerns the rationalization of services provided by the State. This involves the redefinition of the standards of the services provided by the public sector (public services) taking into account quality aspects. The price of services will be newly defined and the share of co-financing by the users in specific

cases will increase as necessary. The program classification used for the preparation of the budget and its execution will be of significant value in this regard. This policy should contribute to reduce the cost of public services both in terms of wages and material costs as reflected in the dynamics of the wage bill and intermediate consumption (Table 3.4). This type of measures should lead to a reduction of total government expenditure of up to 0.4% of GDP by 2013.

The third set of policy measures relate to the rationalization of the distributive role of the State. These involve social transfers, pension and healthcare benefits. The aim is to make the social transfer system more transparent and fair in favor of those in more need. In the case of public insurance (health and pension) the measures will aim at gains in efficiency and financial sustainability. With regard to the social transfers system a government working group has elaborated proposals for its rationalization. One of the key policies concerning the system of social transfers is the setting up of an information system, which will contribute to enhance accountability and rationalization by 2011. At the same time, the system of granting social transfers will be streamlined by determining the right to transfers based on a single income base. Currently different income bases are used for granting transfers and there is not a single registry of the transfers an individual or a family is entitled to. Concerning the dynamics, the crisis has resulted in an increase in unemployed and demand for social transfers. The approved budgets for 2010 and 2011 envisage an increase in the total level of transfers. After 2011, with the gradual economic recovery and the introduction of the unified system of social transfers including changes to the system, it is expected that the number of receivers of individual types of transfers as well as the amount of transfers to individual receivers will decline, and their rationalization will result in keeping in 2012 and 2013 the same level reached in 2011. As a result of policies in this field the share of expenditure for transfers to GDP will decline.

The reform of the pension system, in particular the envisaged change of the indexation of pensions to the "Swiss formula" (half inflation and half real wage growth) in 2011 will contribute to intergenerational fairness in the future, fiscal consolidation over the program period and long term sustainability of public finance (Chapter 6). The envisaged healthcare system reform measures in the period 2011-2013 include: the reduction of price of medicine by choosing alternative generics; restrictive policy on sick leave benefits; restriction on the amount of payments for extra time in hospitals and other health institutions and; change in the ratio of health services and medicines covered by obligatory and voluntary health insurances. On the revenue side measures will ensure a widening of the taxable base for social security payments for health to other income from labor (from contractual arrangements, student work, etc.). These measures should contribute towards maintaining the health fund relatively balanced during the program period (Table 3.4).

The fourth type of measures relate to rationalization of programs in favor of those considered development priority of the government including keeping the level of investment high and their financing switched towards EU funds. This policy should contribute to reduce overall expenditure.

In particular Table 5.2 shows that the consolidated gross fixed capital formation financed from domestic sources declines in the program period from 5.5% of GDP in

2008 to a level of 4.2% of GDP in 2013. Nevertheless, taking into account investment financed from the EU funds, that will increase in the program period from 0.7% of GDP in 2008 to 1.2% of GDP in 2013, the total government investment level will remain relatively high throughout the program period.

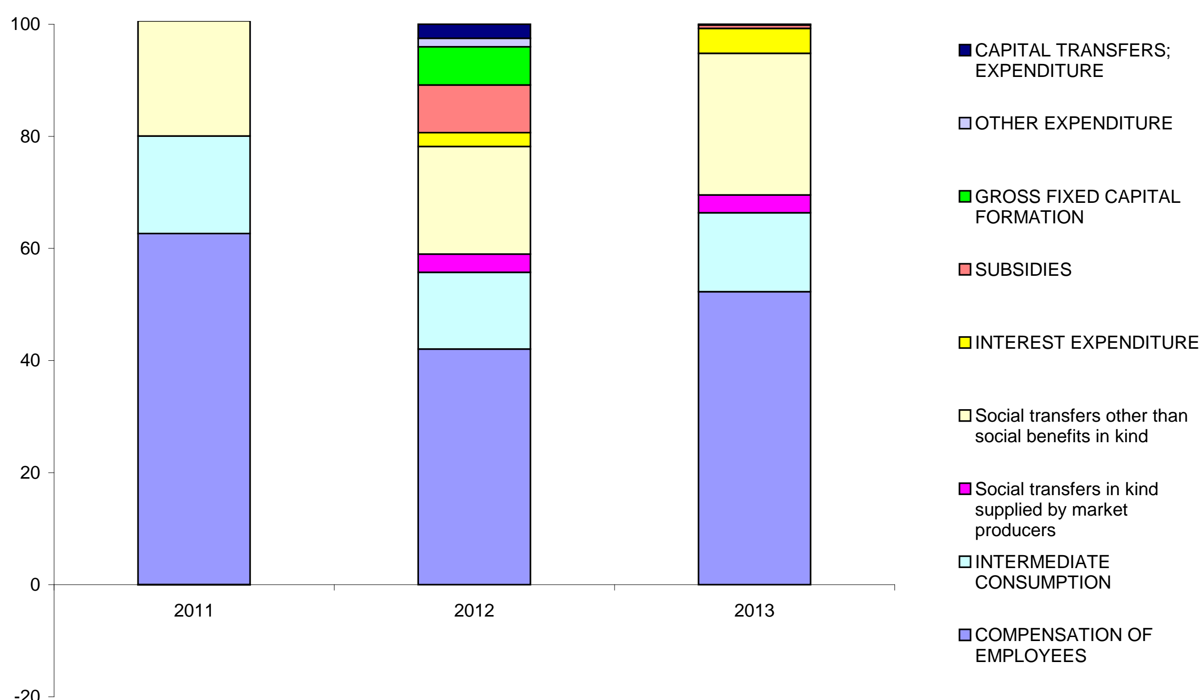
Table 5.2: Gross fixed capital formation, other capital transfers and investment from the EU budget sources

Mio EUR	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Gross fixed capital formation	1,604	1,572	1,656	1,599	1,625	1,625
- percent of G D P	4.32	4.38	4.55	4.20	4.03	3.81
Other capital transfers	433	368	184	170	182	151
- percent of G D P	1.17	1.03	0.51	0.45	0.45	0.35
I. Total general government gross fixed capital formation and other capital transfers (ESA 95)	2,037	1,940	1,840	1,768	1,808	1,776
- percent of G D P	5.48	5.41	5.06	4.65	4.48	4.17
II. General government investment from the EU budget sources	276	379	728	642	565	516
- percent of G D P	0.74	1.06	2.00	1.69	1.40	1.21
Total general government gross fixed capital formation and capital transfers, including investment from the EU sources (I+II)	2,312	2,318	2,568	2,410	2,372	2,292
- percent of G D P	6.23	6.46	7.06	6.33	5.88	5.38

Source: MF RS.

Looking at the effect of the various measures on the expenditure consolidation strategy it can be said that it will rely primarily on its impact on the wage bill, followed by intermediate consumption and social transfers (Figure 5.2)

Figure 5.2.: Composition of the expenditure based consolidation strategy, % of total expenditure reduction



6. SUSTAINABILITY OF PUBLIC FINANCES

Addressing the long-term challenge of population ageing has become more important now due to the crisis and its impact on the public finances. To this end the government set up a working group that prepared a proposal for modernizing the pension system beyond the reform measures introduced in 1999 which are still being implemented. The proposal was submitted to public debate. Currently, changes to the pension system are being drafted into Law. It is expected that some changes will be introduced already in 2011 such as the change in pension indexation formula the effects of which have already been taken into account in this update of the Stability Program. Thus, changes in the pension system will contribute to fiscal consolidation and reduction of the structural deficit in the program period and to long-term stability of public finances.

Among the measures proposed by the working group are the following:

a) Changes in indexation formula from wage growth to wage and inflation growth ("Swiss formula");
b) Changing eligibility criteria for retirement and thus prolonging retirement age;
c) Enhancing incentives to postponing retirement;
d) Increase in the pension-base calculation period;
e) Reducing solidarity by capping pension contributions and;
f) Transferring other non-pension transfers from the pension fund to the State budget.

Once the law is adopted, the Slovenian government will request the Ageing Working Group of the EPC to revise of common estimates of long-term sustainability of public finances for Slovenia which will be reflected in the 2011 update of the Stability Program.

The following two sections present updated baseline projections related to age related expenditure and simulations on the baseline scenario to highlight the potential impact of key reform measures to the parameters of the pension system which are currently under consideration.

6.1. Baseline projections

The update baseline projections are based on 2009 budget realization estimates, approved 2010-2011 budgets and fiscal projections until 2013 (program period). Estimates beyond 2013 until 2060 are based on the latest population projections of Eurostat of Spring 2008 (Table 6.1) and take into account agreed assumptions regarding age related expenditure of the ageing working group including in Table 6.2. Among the assumptions, due to its relevance for overall estimates, it is important to highlight the assumption concerning labor participation rates for Slovenia, under

which Slovenia will not reach by 2050 similar participation rates than those observed in 2005 in most advance member states. [7]

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; Statistical office of Republic of Slovenia

Table 6.2 presents the updated base line projections of age related expenditure. Comparing to the projections in the 2008 Stability Program total increase in age related expenditure in the period 2007-2050 is lower by 1.7% of GDP and pension expenditure is lower by 1.3% of GDP. Total expenditure in pensions will remain fairly constant until the first half of the next decade and then expenditure will increase.

[7] 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

	2008	2009	2010	2020	2030	2040	2050	2060
Total revenue	**43.6**	**41.4**	**40.1**	**39.4**	**38.8**	**38.3**	**37.4**	**37.3**
Pensions	10.1	10.1	10.3	10.4	12.4	15.0	16.9	17.3
Old-age	7.1	7.1	7.2	7.6	9.4	11.6	13.2	13.5
Disability	1.5	1.5	1.5	1.4	1.3	1.3	1.3	1.2
Family	0.9	0.9	0.9	0.9	1.1	1.3	1.5	1.6
State	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2
Other	0.5	0.5	0.5	0.5	0.5	0.6	0.7	0.7
Healthcare	4.3	4.3	4.6	4.7	5.4	6.1	6.7	6.9
Long-term care	1.0	1.0	1.1	1.3	1.7	2.3	2.7	3.0
Education	5.1	5.0	5.2	4.8	4.9	4.8	5.0	5.3
Interest expenditure	0.9	0.9	1.6	1.6	3.3	7.0	13.0	21.1
Total expenditure	**42.9**	**41.7**	**45.5**	**44.1**	**49.0**	**56.5**	**65.7**	**75.0**
Assumptions								
Labor productivity growth	3.7	3.6	3.7	3.1	1.8	1.7	1.7	1.7
Real GDP growth	4.6	4.5	3.4	2.6	0.8	0.7	0.8	1.1
Real GDP growth p.c.	4.0	4.2	3.1	2.6	1.1	1.1	1.3	1.7
Participation rates males (aged 15-64)	76.3	75.8	75.4	75.8	74.2	73.0	73.9	74.3
Participation rates females (aged 15-64)	66.9	67.5	68.0	70.8	69.1	68.4	69.3	69.5
Total participation rates (aged 15-64)	71.7	71.8	71.8	73.4	71.7	70.8	71.6	71.9
Unemployment rate	4.9	4.6	4.6	4.6	4.5	4.5	4.5	4.5
Share of population aged 65 years and over (%)	16.1	16.4	16.6	20.4	25.3	29.1	32.5	33.4

Source: IER, UMAR, MF RS.

6.2. Simulations

While the final pension reform measures are still being drafted, it is possible to assess the implications for pension entitlements and old age related expenditure of some key policy measures that are likely to be part of the modernization of the pension system. Since sustainability of public finances also relates to the level of pension benefits after reform, the simulations also include the impact of changes in various parameters of the pension system on pension benefits and the replacement rate: the ratio between pensions and wages.

Two parameters influencing pension expenditure are of particular importance in light of the dimension of their effect: the retirement age and the pension indexation formula. Simulations concern alternative scenario increases in retirement age (1, 3, and 5 years) and switching indexation of pension benefits from wage growth to the so-called “Swiss formula” (half inflation and half real wage growth). The simulations also combine changes in both parameters simultaneously. Figure 6.1 and Table 6.3 show the different scenarios and measures. The scenarios are ranked by their relative impact on reducing pension and old age related expenditure. Switching indexation of pensions to the “Swiss formula” reduces pension expenditure during the period 2008-2060 by 1.8% of GDP. Extending retirement age by 5 years reduces pension expenditure by 2.3% of GDP. The combination of both measures would halve expenditure on pensions. Under such scenario the replacement rate will decline by 10 basis points.

Figure 6.1: Sensitivity scenarios on change in old-age expenditure, 2008-2060, (%GDP)

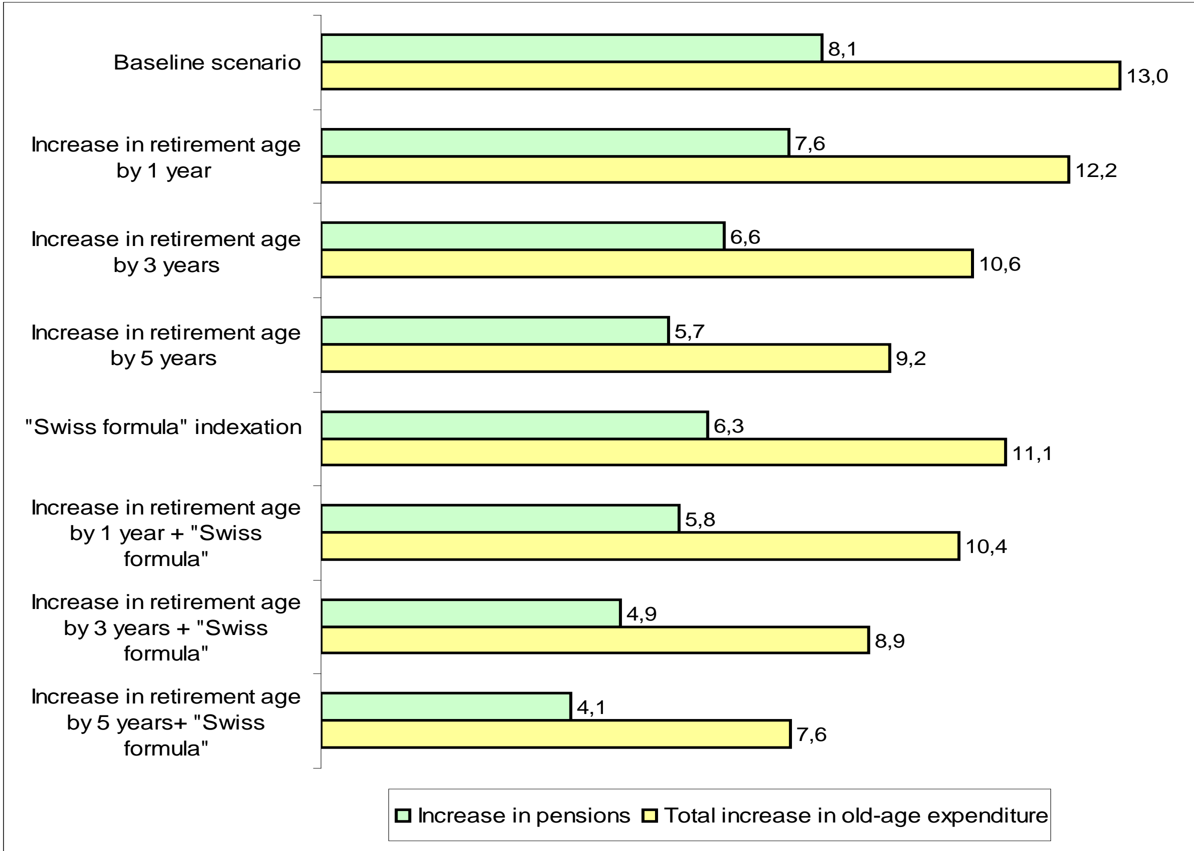


Table 6.3: Sensitivity scenarios – change in old age expenditures

% GDP	Total increase in old-age expenditure **2008 - 2060**	Increase in pensions **2008 - 2060**	**Replacement rates**		
			2008	**2050**	**2060**
Baseline scenario	13.0	8.1	61.9	59.6	59.7
Increase in retirement age by 1 year	12.2	7.6	61.9	58.6	58.9
Increase in retirement age by 3 years	10.6	6.6	61.9	57.0	57.6
Increase in retirement age by 5 years	9.2	5.7	61.9	56.0	56.7
"Swiss formula" indexation	11.1	6.3	61.9	53.5	53.6
Increase in retirement age by 1 year + "Swiss formula"	10.4	5.8	61.9	52.7	52.9
Increase in retirement age by 3 years + "Swiss formula"	8.9	4.9	61.9	51.3	51.7
Increase in retirement age by 5 years+ "Swiss formula"	7.6	4.1	61.9	50.3	51.0

Source: MF RS.

The impact of the pension reform scenarios on sustainability of public finances has been also calculated in terms of indicators S1 and S2. The S1 indicator provides information regarding the fiscal effort (primary balance) necessary to keep the debt below 60% up to 2060. The S2 indicator refers to the primary balance required to meet the intertemporal budget constraint. Table 6.4 shows the impact of policy measures under baseline scenario on the indicators.

Table 6.4: S1 and S2 under the baseline scenario

	S1	**S2**
Base line scenario	6.2	10.5

Source: IER, MF RS

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

By amending the Act on Public Finances the Government intends to centralize public sector borrowing operations and to gradually switch to IMF's GFS 2001 Methodology for the compilation of government accounts.

7.1. Fiscal rule

Slovenia intends to introduce a fiscal rule, which ties the nominal growth of government expenditure to the growth of potential output. Given the objectives of the fiscal consolidation in the present program period, this type of fiscal rule would be insufficient in consolidating the deficit below the reference value. As shown in Table 5.1, the average potential output growth in the next four-year period is estimated at 3.9% while the average government expenditure growth will be 2.2%, reflecting additional restrictiveness of the fiscal policy necessary during the program period. Against this background, the government will decide on its implementation in future updates to the program documents, when the modalities of tying expenditure and the use of potential output growth will be worked out in greater detail.

7.2. Performance-based budgeting

In 2009, simultaneously with the preparation of state budgets for 2010 and 2011, the government launched a project of "target-oriented budgeting". Several working groups (for different spending areas) were established to be actively engaged in the process of budget preparation. Their aim is, above all, the program evaluation and setting measurable objectives and indicators to measure the effectiveness of individual programs. It is a long-term project and its full implications go beyond this program period.

For the preparation of the next state budgets (amendments to the 2011 budget and the new budget for 2012) activities began in the working groups already in January. This will enable more time to substantive work on individual subprograms, programs and policies.

On this basis the Government will build the system of development planning, which will allow monitoring and linking all development planning documents, the hierarchical division of the strategic and operational documents and exact checking for achieving individual, hierarchically differently set up goals.

Such a system will enable more effective setting of priorities within and between individual policies and a more efficient system of budget preparation.

7.3. Fiscal council

Under the Law on Public Finance the Government in 2009 set up a Fiscal Council, a consultative body for independent evaluation of fiscal policies and implementation of

structural reforms. The members of the Fiscal Council were appointed by the Government on a proposal of the finance minister. In November the first constituent meeting was held. The Fiscal Council will perform the tasks specified in the Law on Public Finances:

- ex-post evaluation of the stability and sustainability of fiscal policy as set out in the annual Budget Memorandum and Stability Program and compliance with the rules of the Stability and Growth Pact;
- assessment of the adequacy of fiscal targets with the medium-term macro-fiscal framework;
- annual assessment of the effectiveness of public spending, including EU funds, on the basis of annual accounts;
- assessment of the trends of individual categories of government revenue and expenditure in terms of their impact on the sustainability of public finances, based on annual accounts and adopted budgets for the coming years;
- assessment of compliance of government fiscal policy with the long term sustainability of public finances due to population ageing;
- assessment of the transparency of public finances and the quality of economic forecasts used in the process of budget preparation;
- evaluation of the effectiveness of implementation of structural policies in terms of providing long-term sustainability of public finances, economic growth and employment;
- assessment of general government debt management and guarantees schemes in terms of sustainability and stability of public finances.

Fiscal Council will publish its assessments of fiscal policy and implementation of structural reforms in its annual report.

7.4. Agency for the Governance of Capital Investments of the Republic of Slovenia

The Government is in the process of establishing an agency for management of capital investments of Republic of Slovenia, which will be independent in its operations. Performing its tasks, stipulated by the law, the agency will act with all due diligence and in accordance with the budget principles of transparency, efficiency, economy and effectiveness. The Agency shall prepare a proposal for the Strategy for Governance of Capital Investments on the basis of sectoral policies, prepared by line ministries. The Strategy will include the guidelines of the state as a shareholder or partner of enterprises as well as the manner of achieving the objectives stipulated in the sectoral policies. On the basis of the Strategy Agency will prepare an Annual Plan for the Governance of Capital Investments that will include clearly defined objectives as well as measures for achieving these objectives. The Agency will manage portfolio investments independently, except in the case of selling strategic investments, when prior consent by the Government will be needed. On behalf and for the account of the Republic of Slovenia, the Agency will exercise the rights of a shareholder or partner, especially those of voting rights on assemblies, monitoring of effectiveness of operations and achievement of target profitability of capital, proposing of candidates for members of bodies of enterprises, appearance in takeover procedures and in

procedures before courts and implementation of other rights and obligations that the Republic of Slovenia has as an owner of business shares or stocks in enterprises.

7.5. Agency for public procurement

With objective to increase the efficiency and transparency in public spending, the Government will set up an Agency for public procurement. The aim is to unite the functions of the implementation of public procurement for all direct budget users. The Agency will also participate in the training of civil servants in charge of procurement procedures at the national and local level. One of the first tasks of the Agency will be the preparation of model tender documents, setting up an information system for catalogue ordering of goods and services for the state budget and local governments and transfer of good practices related to public procurement within the Slovenian territory. The Agency will also conduct the most demanding public procurement procedures.

7.6. Redefinition of the Capital Fund (KAD) and the Restitution Fund (SOD)

The Government intends to improve the management of government assets with the establishment of a new institutional framework. Part of this task will be carried out through the Agency for the Governance of capital investment of the Republic of Slovenia and the other part through the changes in indirect ownership of the state.

To this end, the law on restructuring of the Capital Fund, on transferring the rights and mandate of the DSU (government–owned legal successor to the former restructuring and privatization agency) to the Slovenian Restitution Fund and on the investment policy of the Capital Fund and the Slovenian Restitution Fund, has been prepared. On this basis the Capital Fund and the Slovenian Restitution Fund will act as portfolio investors. Within the scope of the law, provisions are included for the extracting from the Capital Fund, a newly founded company, which will manage the pension funds. The Law also provides a means of providing additional funds for pension and disability insurance with an aim of ensuring long-term financial sustainability of the system.

ANNEX 1

CORRECTION OF AN EXCESSIVE GOVERNMENT DEFICIT

The EU Council in December 2009 established the existence of an excessive government deficit in Slovenia and made recommendations for its correction. The Council emphasizes the need for Slovenian authorities to bring the general government deficit below 3% of GDP by 2013 in a credible and sustainable manner by taking action in a medium-term framework. Specifically to this end, the EU Council recommended that Slovenia should:

a) implement the fiscal consolidation measures in 2010 as planned;

b) ensure an average annual structural budgetary adjustment fiscal effort of ¾% of GDP over the period 2010-2013;

c) specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

1. Implementation of the fiscal consolidation measures

The parliament adopted the 2010 and 2011 budgets in November 2009. The 2010 approved budget foresees the withdrawal of fiscal stimulus by the end of the year, government expenditure remaining on a relatively high level. The 2011 budget does not foresee any prolongation of discretionary measures and includes measures for fiscal consolidation, lowering the government expenditure level (Section 5.2). The adopted budget for 2011 already envisages a reduction of the state budget deficit of 1.3% of GDP compared to the 2010 deficit, while the general government deficit reduces by 1.5% of GDP.

2. Annual structural budgetary fiscal effort

The annual reduction of the structural balance in the period 2010-2013 will be 1% of GDP on average (Section 3.2 and Table below).

3. Measures to achieve the correction of the excessive deficit by 2013

Expenditure based fiscal consolidation strategy includes first of all measures for reduction and rationalization of government expenditure: i) reducing the public sector wage bill; ii) reducing government intermediate consumption; iii) rationalizing public services; iv) maintaining the level of social transfers while rationalizing the social transfer system; v) maintaining the level of government investment by switching to financing predominantly from the EU budget. The government will rationalize the healthcare sector and widen the tax base for social security contributions for health,

which will assure a balanced budget of the Health Fund (Section 5.2). The government will continue with the pension reform, including the envisaged change of the indexation mechanism for the pensions (Chapter 6). The Government will keep the level of tax burden stable throughout the program period, which will stimulate the economic recovery, and at the same time will continue to unburden the low income earners (Section 5.1).

Table: Fiscal consolidation in the period 2010 – 2013

in % of GDP	**2010**	**2011**	**2012**	**2013**
General government revenues	43.2	42.9	42.7	42.5
General government expenditures	48.9	47.1	45.9	44.2
General government deficit	-5.7	-4.2	-3.1	-1.6
General government cyclically adjusted balance	-4.2	-2.8	-2.1	-1.0

Source: MF RS.