THE REPUBLIC OF SLOVENIA

CONVERGENCE PROGRAM

2004 - UPDATE

Ljubljana, January 2005

CONTENTS

INTRODUCTION

In accordance with the Council's regulation (EC) 1466/97, an update of the convergence Program is to be submitted annually. This is the first update of the Convergence Program submitted by Slovenia in May 2004.

Since joining the EU on May 1st, 2004 two important events with policy implications have taken place in Slovenia: entrance into the ERM II mechanism on June 28th and the October parliamentary election. Entering ERM II highlights the importance of maintaining the policy mix which has allowed Slovenia to become one of the first new EU members in the mechanism and which will be critical to assure the planned euro adoption in early 2007. The outcome of the October parliamentary elections resulted in the formation of a new government and coalition lead by the Slovene Democratic Party (SDS). The new government took office on December 3rd, 2004.

These events have taken place against the background of an economic recovery since the second half of 2003, further strengthened in 2004. At the same time, inflation continued to decline, the exchange rate has been stable, unemployment rate reduced, employment increased slightly and a fairly balanced current account position maintained. Fiscal policy has remained prudent and the slight upward deficit revisions reflect the methodological change concerning the scope of the general government already notified in the September EDP.

The key challenges for fiscal policy remain unchanged: to facilitate the adoption of the euro in 2007; to cope with budgetary commitments arising from EU and NATO memberships; to improve the quality of public finances; and to achieve a close-to-balance position in the medium-term according to the Slovenian fiscal policy goal. In particular achieving a close-to-balance position in particular would add resiliency to the economy to dampened business cycle fluctuations and secure sustainable public finances in light of future spending pressures related to population ageing. Meeting these challenges requires deepening the ongoing process of expenditure rationalization, which includes public expenditure reduction and restructuring.

The macroeconomic scenario and fiscal projections presented in this update are based on the latest medium-term forecast for 2004-2007 (October 2004), the preliminary budget execution in 2004, the new government's planned supplementary budget for 2005 and fiscal projections for the period 2006-2007. The fiscal projections were produced taking into account policy changes introduced since the time the first Convergence Program was presented in May 2004 and assuming that the policy envisaged in the first Convergence Program will be carried out in the future ("no policy change scenario"). The fiscal projections also include the effect of the revision of the coverage of general government following EUROSTAT recommendations, which resulted in the inclusion of two previously extrabudgetary funds within the scope of the general government.

It is important to stress that the new government took office only recently and the fiscal projections correspond to the policy scenario envisaged in the first Convergence Program (May 2004). Policy changes as will appear appropriate to the new government will be included in the next update of the Convergence Program. However, it should be pointed out that the new government has clearly announced the adoption of the euro in 2007 as one of its central goals. In this regard the broad framework for conduct of economic policies has thus not changed and the "no policy change" assumption of this update is justified.

1. POLICY FRAMEWORK AND OBJECTIVES

The objective of economic policy is to create conditions for a faster and sustainable welfare increase in Slovenia to the level of more developed EU members. This goal will be achieved by maintaining a stable and broadly balanced macroeconomic environment, including sustainable fiscal policy and reduction of inflation, thus assuring a smooth process of monetary integration, and by creating conditions for faster growth and increase in employment by increasing competitiveness and flexibility of the economy and by creating a friendlier environment to private sector development, with strong emphasis on small and medium size enterprises.

Slovenia has formally initiated the process of monetary integration by joining ERM II in June 2004 with the aim of adopting the euro in 2007. In the period leading to Euro adoption, Slovenia is hence committed to fulfill the other criteria besides the Maastricht fiscal and interest rate criteria which have already been met. Therefore, economic policy will contribute to continuous reduction of inflation in a sustainable manner to the level corresponding to the Maastricht criteria and to maintain exchange rate stability during this period. In particular, the disinflation process is underpinned by coordinated monetary, fiscal and incomes policies. The government will continue with policies that contribute to reduce inflation in a sustainable manner, as also stated in the communiqué of ERM II Committee, by maintaining prudent fiscal and wage policies and establishing effective competition in all sectors where it is still inadequate.

In the period covered by the convergence program (2004-2007) which corresponds to the process of monetary integration, the objectives and targets of individual economic policies are:

Fiscal sustainability: sustained reduction of the structural deficit towards a close-to-balance position. The structural deficit will decline from a level of 1.7% in 2004 to 1.0% in 2007. During the program period, the deficit will not exceed the 3% of GDP Maastricht threshold.

Price stability: monetary and exchange rate policy during ERM II participation will maintain the stability of the exchange rate around the central parity of 239.64 SIT/EUR. Fiscal, wage and structural policies will contribute to this objective.

Competitive wage policy: Income policy as agreed by the social partners for the period 2004/05 and which is assumed to remain place until the end of the program period will ensure that wage growth lags behind labor productivity growth by at least

1 percentage point and will enhance adaptability of wage setting to a changing economic environment.

Improve competitiveness and adaptability of the economy: structural policies will be geared to improve productivity, increase competition, increase employment and improve business environment.

1.1. Fiscal sustainability and fostering of nominal and real convergence

Fiscal policy during the program period is oriented towards assuring long-term sustainability of public finances by gradually reducing the structural deficit towards a close-to-balance position and consequently lowering the debt-to-GDP ratio. Pursuing such a policy target allows not only for better preparation to cope with long-term costs related to ageing population, but also contributes to price stability in the process leading to monetary integration and enhances the responsiveness of fiscal policy to asymmetric shocks.

Although fiscal policy aims at reaching a close-to-balance position as soon as feasible, the target will not be met during the program period. However, substantial progress will be made in reaching the target. There are various reasons that make a more ambitious and at the same time sustainable reduction of the deficit during the program period unfeasible, inter alia, the undergoing restructuring of present high share of mandatory expenditures that due to the legal framework can only be carried out at a slower pace, additional financial commitments deriving from EU and NATO membership, the need to increase investment in knowledge and infrastructure (real convergence) and that funding must be provided for co-financing of programs and projects in order to be able to draw EU funding for growth enhancing priorities and assure sustainable position towards EU budget.

Although a close-to-balance position will not be reached during the program period, due consideration should be given not only to the progress that will be made on the path towards reaching the target, but also to the relatively low level of general government debt at the end of 2004 (30.2% of GDP) as well as the debt dynamics which foresees that the debt will not increase beyond 31% of GDP during 2005-2007. Similarly, the fact that public expenditure pressures arising from population ageing will not be significant until the third decade of this millennium should also be taken into account.

Being a medium-developed EU member state, Slovenia still needs to finance large investment projects, particularly in the field of infrastructure which will enhance its growth potential. Although the new government has committed itself to the prompt enactment of a law establishing an up-to-date Private Public Partnership, its effects are not expected to materialize fully during the program period. Hence, a relatively high share of general government investment and investment transfers as percentage of GDP is envisaged during the program period. This reflect the fact that inspite of Slovenia’s relatively advanced stage of development compared to the new EU members its infrastructure is still below EU average. Similarly, account should be taken of the fairly neutral budgetary effect of EU integration unitl 2006 if its’ direct and indirect[1] effects are considered. Therefore, the gradual fiscal consolidation path reflects the objective of financing growth enhancing priorities thus the quality of the policy and the financial constraints.

Pursuing a reduction in structural deficit in line with the SGP is also conceived as a pre-emptive move to offset potential risk of demand and inflationary pressures arising from the objective of an effective monetary integration. Slovenia already meets Maastricht fiscal criteria and in the period 2005-2007 the 3% of GDP deficit ceiling will not be breached. This will be ensured by the budgetary framework that allows for precise targeting of the budget deficit figure (Box 1).

Box. 1 Budget formulation and deficit targeting

Slovenia is the only EU country that adopts complete budgets for two consecutive years on a rolling basis since 2002. The budget formulation framework, a two-stage process, provides the government with the possibility to target precisely the budget approved figure. In the first stage the government's cabinet sets out the overall expenditure framework for two years and in the second it confirms the budget appropriations within the expenditure limits.

The existing budgetary procedure does not maintain expenditure ceiling regardless of macroeconomic circumstances, but provides for the option to adjust the first and second year budgets in light of changing macro-economic circumstances.

The budgetary framework allows for precise deficit targeting by means of budget execution procedure without the need to recourse to supplementary budget legislation. Under the scenario of changes in macroeconomic circumstances or occurrence of new commitments the government can determine the suspension of adoption of new commitments within the agreed limits of the Budget Execution Law. Furthermore, in the case of changing economic circumstances reflected in lower revenues than approved by parliament the government can reduce expenditures, and if the revenue short-fall is higher than a given threshold it can only increase expenditure up to a limit set by the Budget Execution Law (e.g. 2004).

Given the budgetary framework that allows for precise deficit targeting, the risk for the general government deficit to exceed the deficit targets during the period 2005-2007 is very low.

1.2. Monetary policy framework and relation with price and exchange rate stability

Slovenia joined the ERM II on 28 June 2004. Entry into the ERM II was made possible by sustainable nominal convergence and disinflation trends, supported by credible coordination between the Bank of Slovenia's monetary policy and the government's policies in line with the Joint Program for ERM II entry and adoption of the euro. When joining the ERM II the Slovenian government committed itself in the communiqué of the ERM II committee to continue to take measures to reduce inflation in a sustainable way. This involves maintaining prudent fiscal policy, establishing effective competition

[1] VAT shortfall resulting from replacing border controls by the European declaration system.

in all sectors where it is still inadequate and improving regulation in sectors where there are monopolies.

Monetary policy will continue to be focused on the stability of the nominal exchange rate around the central rate. The joint assessment[2] at the ERM II entry was that the market exchange rate for the Slovenian tolar reflected an appropriate balance between real and nominal convergence. After ERM II entry the Bank of Slovenia successfully stabilised tolar exchange rate close to the central parity of SIT 239.64 for EUR. The deviations of the market rate from the central rate during the first period since ERM II entry have been negligible. The average deviation of the exchange rate on the spot foreign exchange market[3] from the central rate during the period from ERM II entry to the beginning of October was 0.09%, with a maximum upwards deviation of 0.24% and a maximum downwards deviation of 0.18%.

The setting of nominal interest rates in the ERM II environment depends on factors that are relatively independent from Bank of Slovenia decisions, above all:

- interest rates in the eurozone, which reflect the ECB's monetary policy stance and
- foreign investors' perception of the country and currency risk premiums

If monetary policy is to be consistent with the stable exchange rate, it has limited ability to adjust interest rates to a level that would restrain excess demand if it occurs (see section 4). The capacity of fiscal policy to adjust to the new conditions and to take on the main burden of policy actions in case of demand shocks is therefore crucial for the period of ERM II participation.

1.3. Competitive wage policy

The target of the real gross wage per employee to lag behind labor productivity growth by one percentage point is being met. The social partners concluded a Social Agreement for 2003-2005 at the end of April 2003. They committed themselves to keep the real rise in the gross wage per employee behind labor productivity growth by at least one percentage point. This provided the basis for adopting the wages policy agreement for the public and private sectors. The real gross wage per employee will rise by around 2.0% in 2004 and will lag behind the anticipated 3.6% labor productivity growth by more than one percentage point.

The gross wage per employee in the private sector is anticipated to increase in 2004 by around 3.0%, which is by 0.5 of a percentage point above the spring forecast. The main reason is a better overall economic performance and slightly bigger effect of

[2] In setting the central rate a consensus was required among the Slovenian government, the Bank of Slovenia, the European Commission, the ECB and the governments and central banks of the eurozone and Denmark as a participant in the ERM II.

[3] The spot market is intended for concluding transactions to be settled within two working days of the contract being concluded. All bank transactions with companies, households and non-residents and all transactions between banks are considered when the rate is calculated. The figures are published in Table 2.13.2 in the Bulletin of the Bank of Slovenia.

the adjustment in line with “The Wage Policy Agreement for Private Sector 2004-2005”[4] than anticipated in spring (due to lower inflation).

The real gross wage per employee in the public sector in 2004 will be around 0.4% below the 2003 level and will have fallen in real terms in all subsectors, with the exception of education. The forecast of wage growth in the public sector for 2004 is below the spring forecast, when 0.5% real growth was expected. This is mainly due to a smaller wage increase in July 2004 since the introduction of a new wage system in public sector was deferred until July 2005.[5]

In 2005, the average real gross wage per employee is expected to rise by 2.2%, thus lagging behind the forecasted 3.5% labor productivity growth. The forecast of real gross wage per employee in the private sector (around 2.5%) for 2005 takes into account the 2.7% August wage adjustment as set down in the “The Wage Policy Agreement for Private Sector 2004-2005” and a somewhat slower economic activity. The forecast also takes into account a 3.0% base wage adjustment as stated in the agreement and its’ review will take place at the beginning of 2005. The social partners should review the anticipated growth in base wage taking into account the different factors on which the adjustment percentage of the base wage in the public sector for 2005 depends[6]. The real gross wage per employee in the public sector will increase by around 1.2%. The wage growth in the public sector is forecast on the presumptions that negotiations on a new salaries’ system will be concluded in the first half of 2005 and that wages will be paid out under the new system as of July 2005.

In 2006, the average real gross wage per employee in the economy is expected to increase by 2.4%, lagging behind the 3.3% growth in labor productivity by around one percentage point. In the private sector, a better economic environment is expected to speed up the growth in gross wages, however a new agreement among social partners on wage policy for 2006 and 2007 is required. Assuming that the existing wage policy will not change significantly, real gross wage per employee could growth by around 2.6%. Similarly, the social partners in the public sector will also have to reach a new agreement on wages policy for 2006 and 2007 for which no policy change is envisaged.

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[4] Under the Agreement, all gross wages per employee in the private sector must increase by a minimum amount of SIT 5 thousand, in form of a wage supplement and as an integral part of the salary. The sum varies in line with the average gross wage in individual sectors. However, the parties to the collective branch agreements can opt for a different manner of adjusting wages. In addition to the adjustment amount, wages can increase due to a rise in labor productivity. However, in this case the basic guideline of real gross wage growth lagging behind labor productivity growth by at least one percentage point should also be observed.

[5] Act Amending the Public Sector Wage System.

[6] The adjustment mechanism for 2005 agreed upon by the social partners took into account 52% of the estimated 4% rise in consumer goods prices (alcohol and tobacco excluded) in Slovenia and 48% of the estimated 2% rise in consumer goods prices in the EU. The current estimates of the price rises of consumer goods in both Slovenia and the EU indicate that the adjustment mechanism should be reduced by around 0.5 of a percentage point.

1.4. Improving competitiveness and adaptability of the economy

To enhance the Slovenian economy's competitiveness and adaptability to the new environment, structural reforms are essential. Structural policy will be geared towards improving productivity, increasing competition, raising employment and improving the business environment. The updates of the 2004 BEPG also included, for the first time, country-specific guidelines for the ten new member states. Regarding the structural policy, BEPG's specific recommendations for Slovenia were: (i) increase employment rates, especially for older workers; (ii) improve conditions for sustained productivity growth; and (iii) and promote the development of effective competition in all segments of the economy, notably in network industries. In line with these recommendations, the Government has adopted several measures which the new administration is committed to expand and speed up.

As a part of the active employment policy, the Government has introduced several measures to improve conditions in the labor market. Most of them are geared to stimulate employment and create new jobs through subsidies and tax incentives aimed at employers. As a part of the tax reform, the modified income tax brackets and the higher threshold for payroll taxes lowered the tax burden for the lower income groups. With the intention to improve employment among older workers, employers are now exempted from paying social contributions when hiring unemployed persons older than 55 years.

The government also took steps towards creating a corporate friendly environment by improving efficiency of public administration, creating incentives for entrepreneurship, reducing administrative barriers, updating tax legislation and increasing investment in research and development. New legislation was adopted to increase public administration efficiency, with a focus on employee training and human resource management. Two important acts (the Act on the Supportive Environment for Entrepreneurship, and the Act amending the Small Business Act) were adopted with the view of promoting entrepreneurship and SMEs. In addition, the One-Stop-Shop system (VEM system) was further developed and the setting up of the institutional framework for R&D activity continued. With the decision to finance the establishment of centers of excellence, measures were taken to link the public research sphere to the business sector and to speed up the transfer of know-how among them and to create a more favorable environment for R&D. In the field of education and training, efforts are aimed at the implementation of lifelong learning programs in the area of teacher training, vocational guidance, extension of local/regional centers of lifelong learning, etc. In accordance with the Bologna Declaration, the modernisation and development of education programs continues, including the post-graduate level. In financial services, progress has been made in the implementation of reforms in the field of regulation and harmonisation of legislation with the European directives, creating possibilities for enhancing the sector's competitiveness.

During 2004, legislation in the field of competition protection has been substantially aligned with the EC legislation. The Competition Protection Office, which monitors the protection of competition regarding restrictive agreements, abuse of a dominant position and corporate concentrations and is responsible for the implementation of general competition rules, was given new sanctioning powers. Independent sectoral regulators (agencies) are already operative (section 5) and are overcoming initial difficulties to achieve greater efficiency.

The liberalisation process in the network industries continues and progress has resulted in improved competition. The legislation governing network industries was harmonised with EC legislation and, with some exceptions, the entry to the market is free. Competition exists in all segments of the telecommunications market, except for domestic calls in fixed telephony, where the institutional monopoly was abolished. Providers of voice services over the Internet protocol (VoIP; 22 operators) and international transmission networks operators, providing international calls (11 operators) became significant competitors to the incumbent (Telekom Slovenije). There are also 3 operators in the mobile telecommunications, where two of the operators have the status of operators with significant market strength. The deregulation of the electrical energy market separated the activities of production, transmission, distribution and supply, thus providing for competition in the industry market. On 1 July 2004, the electrical energy market opened for all non-household customers and the number of eligible customers rose significantly afterwards (before July 2004 there were around 8,000 eligible customers). Around 10% of distribution customers switched suppliers and prices for eligible customers dropped slightly.

2. ECONOMIC OUTLOOK

2.1. Cyclical developments and current prospects

Since the spring, the dynamics of the projected economic growth in the international environment have changed significantly. As a result of the better than expected performance in the first three quarters, a stronger growth rate is now expected in 2004. However, forecasts for 2005 have been revised downwards slightly compared to spring forecast, most notably in Germany and Italy due to the effects of higher oil prices. Economic growth in the euro area is thus expected to reach 1.8% this year (1.7% in the spring forecast) and 2.0% in 2005 (2.1% was forecast in spring). Similarly, economic growth forecasts for those new EU member-states, which are Slovenia’s main trading partners, are also slightly higher for 2004 and slightly lower for 2005 compared to the spring forecasts (with the exception of Poland). The same holds for Croatia, Bosnia and Herzegovina and Macedonia, while in Serbia and Montenegro and Russia; higher growth is also expected in 2005 compared to spring forecasts. Although the assumptions on the international environment differ slightly from the Commission in autumn (which was published later and could not have been considered in ours), the differences are relatively small and would not have a significant impact even if they were included.

The main discrepancy with respect to the spring assumptions concerns the price of oil. Taking into account the average price per barrel in the first three quarters, which stood at USD 36 per barrel (Brent crude), and considering significant unpredictability of the future trends of these prices, the current assumption for the average oil price for the year as a whole is USD 37. Drawing in part on the forecasts of international institutions at the time of the preparation of the autumn forecast[7] and on the technical assumption of an unchanged euro/dollar exchange rate[8], we assumed that oil prices would remain at this level in 2005. The difference between IMAD's and Commission's projection on average oil prices per barrel for 2005 is high (USD 37 and USD 47 per barrel, respectively), and is mostly reflected in the forecast of inflation for Slovenia (see 2.2). Its impact on the GDP forecast, which would be channelled mostly through international environment growth, is lower, as the IMAD's and Commission's assumptions on the economic growth in major trading partners are very similar.

Slovenia's economic growth started to pick up at the end of 2003 and remained strong in the first half of this year. After rising to 2.5% year on year in the last quarter of 2003 mainly due to the recovery of exports, the growth of gross domestic product reached 3.8% and 4.6%, respectively, in the first and second quarters of this year. This strengthening was higher than expected, deriving chiefly from the high growth of exports and stocks, and partly also from the slightly faster growth of gross fixed capital formation. The high real growth of exports (11.5% in the first half-year in year-on-year terms) was in part the consequence of the one-off effect of Slovenia's entry into the EU and the consequent surge in exports to the countries of former Yugoslavia before 1 May (up 16.6% in the first four months year on year, measured in euros; mainly to Bosnia and Herzegovina and Macedonia). These markets, in addition to Russia (21.7% growth in nominal terms), denote the main deviation from the spring forecast. Similarly, exports to the main European trading partners as well as to the 'non-traditional' partners from the EU15 already rose considerably in the first half of the year which was a consequence of the stronger and earlier recovery of these economies than projected in the spring forecast. The growth of exports to the new EU members remained close to the high level of the previous year.

The real growth of gross fixed capital formation was higher than last year (7.3% in the first half year; 6.3% in 2003) mainly due to the rise in investment in machinery and equipment. Investment in civil engineering continued to be strong, while housing investment experienced sustained growth. Stocks rose significantly (contributing 1.3 percentage points to the growth in the first half-year), notably in the second quarter, which, according to our estimates, can in part be seen as a consequence of Slovenia's entry into the EU and the ensuing surge in merchandise imports which are subject to higher customs rates according to the new foreign trade regime (from Russia). Real growth of private consumption strengthened (reaching 3.5% in the first six months year on year; 2.7% in 2003) as the result of the rise in employment (especially informal) along with the faster real wage growth in the private sector and the increase in the long-term household borrowing from banks. Real growth of government consumption was low in the first half-year (0.8%). Imports also recorded a high real rise (12.9%) due to the stronger growth of domestic consumption and exports.

[7] Mid-October 2004.
[8] The euro/US dollar exchange rate is 1.22 dollars for 1 euro. This rate is set on the basis of movements seen in the last few months and represents the so-called technical assumption: unchanged euro/dollar exchange rate for the entire period covered by the forecast.

The autumn economic growth forecast was revised upwards to 4.0% for 2004 and to 3.8% for 2005[9]. The increase (from 3.6% and 3.7%, respectively, projected in the spring forecast), given the small changes in forecasts for the international environment (see above) and the essentially unchanged growth of domestic consumption, derives from the smaller negative contribution of international trade as a consequence of export growth being higher than expected in the first half of the year. The autumn forecasts project a slowdown in exports for the second half of the year. Nevertheless, for the year as a whole it should come in at relatively high, 8.5% real growth (spring forecast 5.5%). A moderate decline in exports is expected for 2005 (5.8%), mainly because of the smaller rise of exports to the countries of former Yugoslavia and Russia along with the sligthly lower growth of exports to EU countries.

Domestic spending should continue to expand in 2004 and 2005, boosted by the growth of private consumption as well as investment. The forecast of the growth and structure of domestic consumption for both years remains practically identical to the spring forecast. Private consumption growth (3.5% in 2004, 3.4% in 2005) is underpinned by the new cycle in the consumption of durable goods, which is estimated to have already started in 2003 and is partly stimulated by the disburdening of household income from the loans raised in 1999. Stronger private consumption is also encouraged by the expected gradual improvement in labor market conditions and the low level of nominal interest rates in the money market, converging to the level in the euro-area. We further expect impacts of the release of funds from the first national housing savings scheme, as some of these savings should turn into consumption. Growth of real gross fixed capital formation should continue to be strong (7.4% in 2004 and 7.0% in 2005). In the second half of 2004, year on year growth of investment in machinery and equipment is projected to decrease, investment in infrastructure should rise moderately, while growth of housing investment is expected to remain at the current level. In 2005, investment growth should rest primarily on investment in machinery and equipment (private investments). Housing construction is also projected to keep rising, while civil engineering should maintain the high level recorded in the last two years. The forecast for government consumption growth (2.7% in 2004 and 2.9% in 2005) is in line with the adopted budget for 2004 and the draft budget for 2005; forecasts have changed slightly since the spring due to changes in the structure of government expenditure. The stronger growth of exports also influenced higher growth of imports in 2004 (9.2%) compared to the spring forecast (6.8%). The net contribution of international trade is still expected to be negative both this and next year, although slightly less than projected in spring (-0.7 of a percentage point for the two years together, compared to the spring projections of -1.0 for this year and -0.7 for 2005).

[9] The difference between the EC's and the IMAD's GDP forecasts for 2005 (EC 3.6%, IMAD 3.8%) is mainly the result of the EC’s lower forecast of gross fixed capital formation by 1.3 percentage points. We estimate that the main reason for this difference is EC’s lower forecast of investments in equipment. On the other hand, EC’s forecast of contribution of stockbuilding to GDP growth in 2005 (0.5 of a percentage point) is higher than IMAD’s projection (0.1 of a percetage point).

Table 2.1: Growth and associated factors*

Percentages unless otherwise indicated	ESA Code	2003	2004	2005	2006	2007
1. GDP growth at constant market prices (14+15+16)	B1g	2.5	4.0	3.8	3.9	4.0
2. GDP level at *current* market prices (SIT mio)	B1g	5,747,168	6,194,500	6,626,000	7,066,400	7,546,500
3. GDP deflator		5.5	3.6	3.1	2.6	2.7
4. CPI change (annual average)		5.6	3.6	3.0	2.7	2.6
**5. Employment growth ** **		-0.3	0.4	0.3	0.4	0.5
6. Labor productivity growth * **		2.8	3.6	3.5	3.5	3.5
Sources of growth: percentage changes at constant prices						
7. Private consumption expenditure	P3	2.7	3.5	3.4	3.1	3.4
8. Government consumption expenditure	P3	2.6	2.7	2.9	2.9	2.8
9. Gross fixed capital formation	P51	6.3	7.4	7.0	5.5	6.0
10. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	1.4	1.5	1.5	1.6	1.5
11. Exports of goods and services	P6	3.2	8.5	5.8	6.6	6.6
12. Imports of goods and services	P7	6.8	9.2	6.5	6.5	6.3
Contribution to GDP growth						
13. Final domestic demand (without inventories)		3.6	4.4	4.4	3.8	4.1
14. Change in inventories and net acquisition of valuables	P52+ P53	1.1	0.3	0.1	0.2	0.0
15. External balance of goods and services	B11	-2.2	-0.7	-0.7	-0.1	-0.1

Source: Statistical Office of the Republic of Slovenia (SORS), Bank of Slovenia; forecasts: Institute for Macroeconomic Analysis and development (IMAD).
Notes: * Forecasts of the Institute for Macroeconomic Analysis and development (IMAD).
** Employed population, domestic concept, according to national accounts definition.
*** Growth of GDP at market prices per person employed at constant prices.

The current account of the balance of payments should remain close to equilibrium in 2004 and 2005 (-0.2% and -0.4% of GDP). This forecast takes into account the projected growth of exports and imports, which will result in a higher trade balance deficit in 2005, even though terms of trade are expected to improve slightly on average in the baseline scenario. In the whole period we also expect the gradual increase of reinvested earnings, which will widen factor services deficit. However, the surplus in services balance should increase slightly as well as the surplus in current transfers, which would help offsetting higher deficits in trade and factor services. Taking into account all factors that influence current account balance, the wider deficit than in baseline scenario, which could result from stronger growth of domestic demand compared to the baseline projections, is not very likely (for the risks of demand boom and its impact on economic activity and external accounts see chapter 4.1).

Table 2.2: Current account of the balance of payments

	2003	2004	2005	2006	2007
1.Current account of the BoP, EUR million	-91	-60	-100	-125	-145
2. Current account of the BoP, % of GDP	-0.4	-0.2	-0.4	-0.4	-0.5

Source: BoS, IMAD's forecast

In 2006 and 2007, economic growth is projected to accelerate to around 4%. The relatively strong rise in domestic consumption should continue, but at a slower pace compared to 2004 and 2005. Growth in investment activity is still expected to exceed GDP growth, while investment should focus more on productive private investment, thereby encouraging competitiveness of the Slovenian economy. Growth in housing construction should also be maintained. Private consumption should broadly keep up the current level of growth due to the favorable developments in the labor market. Credit activity should increase in line with economic activity (Box 2).Export growth should be sustained at a relatively high level on the assumption of relatively favorable conditions in the international environment and anticipated improvement in competitiveness. The current account should record only a moderate deficit of up to 0.5% of GDP.

Box 2. Credit developments in medium term

The terms of financing should remain relatively favorable over the medium term. The sustained fall in inflation during nominal convergence process allowed real interest rates to remain at a level that prevented excessive lending and consumption. After ERM II entry the difference between Bank of Slovenia main refinancing rate and ECB interest rate for main refinancing operations has been 100 basis points. Such difference currently seems to be in line with market expectations.

The total amount of domestic and foreign financing is expected to increase in the years ahead. The expected development is in line with increased economic activity and consequently rising domestic consumption. In line with the ongoing restructuring of debt, the government borrowing from domestic banks will be moderate. With relatively strong economic activity, borrowing by companies is expected to remain at a relatively high level. The trends from this year are likely to continue.

Households' borrowing will remain in line with projected private consumption growth in the years ahead. The trend of increased long-term borrowing at the expense of short-term borrowing is expected to continue. The recovery of investment expenditure will continue to generate the demand for long-term lending.

The growth in monetary aggregates will ease, but with a varying dynamics. The slow growth of broad monetary aggregates has been largely a consequence of the convergence of deposit interest rates and hence a shift out of savings into other forms of investment, mostly into mutual funds. It is expected that the slow growth of broad monetary aggregates will continue. In line with the increased economic activity and falling inflation, the growth in narrow money is expected to be more moderate.

In line with the accelerated economic growth labor market’s performance should gradually improve in 2005. According to the national accounts, the level of employment which contracted in 2002 and 2003 is expected to grow (by 0.4% in 2004 and 0.3% in 2005). Accordingly, unemployment is expected to fall at a somewhat faster pace.

Table 2.3: Employment and unemployment

	2003	2004	2005	2006	2007
1. Employment according to the SNA (% growth)	-0.2	0.4	0.3	0.4	0.5
2. Registered unemployment rate (%)	11.2	10.7	10.2	9.7	9.2
3. Unemployment rate by ILO (%)	6.7	6.4	6.1	5.9	5.8

Source: SORS, IMAD's forecast

2.2. Inflation

Continued implementation of the key macroeconomic policy measures underpinned the planned lowering of inflation during 2004. After a rise in the second quarter largely caused by higher oil prices, it declined again in the third quarter due to strong seasonal impacts. Inflation trajectory reverted during October and November only to fall again in December. The end of the year inflation was 3.2% while the average was 3.6%. The faster lowering of (core) inflation was underpinned by the tolar exchange rate's stabilisation carried out approximately six months before the date set when the spring inflation forecast was prepared. Moreover, the cuts in food prices resulting from the abolition of customs duties and other changes in business operations following EU entry reached the upper limit of the forecast interval. The contribution of oil prices to inflation in the first nine months, on the other hand, was much higher than projected, accounting for around 40% of this year's consumer price rise.

Inflation should gradually decline further in 2005, falling to below 3% by the end of the year[10]. In the absence of any major shocks from the international environment, the implementation of the adopted economic policy measures is expected to help reduce inflation further. The monetary policy guidelines will continue to play the key role in this process by keeping the exchange rate stable around the central parity. With regard to the administered prices policy, we expect the government to further pursue the guidelines set out in the Administered Prices Rise Plan for 2004 and 2005. According to this plan, price increases under various regulatory regimes should not exceed the growth of market-determined prices, thereby contributing no more than 0.4 of a percentage point to inflation. The co-ordination between the government and independent regulators involved in the shaping of prices in telecommunications, postal services, broadcasting, and electricity distribution should contribute to subdue inflationary pressures. Furthermore, the forecast includes the assumption that the government will continue to make counter-cyclical adjustments to excise duties on liquid fuels, thereby buffering the high volatility and, in particular, the secondary effects of oil price changes. Thus, the overall contribution of tax and excise duty rate changes should not exceed 0.3 of a percentage point in 2005. In accordance with the guidelines of the adopted Social Agreement, the wage increases in the public and private sector are not expected to cause additional inflationary pressures from the

[10] The difference between the EC's (3.9% in 2004, 3.4% in 2005, and 3.0% in 2006) and the IMAD's inflation forecasts is due to two factors. The first one is of a technical nature, namely the EC has published its forecast for the harmonised index of consumer prices (HICP), while the IMAD forecast relates to the consumer price index (CPI). The difference between the two forecasts is due mainly to their different dynamics in the third quarter of 2004. The second reason for the divergence between the two forecasts is associated with different assumptions about oil price dynamics in the last quarter of the year. The IMAD had assumed that the prices of oil would cease to increase in the last quarter of 2004, which is not the same assumption as was used by the EC.

demand side in 2004 and 2005. Therefore, in the absence of external shoks the year-on-year price growth is expected to reach 2.9% in 2005, with an average inflation not higher than 3.0%.

Table 2.4: Inflation

	2003	2004	2005	2006	2007
1. Inflation rate (annual average, %)	5.6	3.6	3.0	2.7	2.6
2. Inflation rate (Dec/Dec, %)	4.6	3.2	2.9	2.7	2.5

Source: SORS, IMAD's forecast

Given the policy measures described above, the inflation differential with respect to the EU in the future will be explained mainly by structural factors. Inflation in Slovenia is expected to be 1.0 to 1.5 percentage points higher than the inflation in the most developed members of the EU in the next two years. This is explained by structural features in the non-tradable sector, which create constant upward pressures on prices and of faster productivity growth in the Slovenian economy compared to the main trading partners (Balassa-Samuelson effect). For a sustainable reduction of inflation it will therefore be necessary to continue the process structural reforms, mainly in those sectors where prices are regulated by the government as well as in financial and labor markets.

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1. Policy strategy

The new government is committed to a fiscal policy that will facilitate the process of monetary integration and improve the quality of public finance to enhance real convergence during 2005-2007. The general government's deficits both in current and structural terms will decrease gradually. Hence, Slovenia will continue to meet the Maastricht fiscal criteria.

The pace of deficit reduction only partially reflects the undergoing consolidation effort in view of the stringent public sector wage policy and the following considerations: the estimated neutral budgetary impact of EU membership when the direct and indirect budgetary effects associated to this process are taken into account; the undergoing restructuring of present high share of mandatory expenditures that due to the legal framework can be carried out only slowly; the gradual increase in defense expenditure to 2% of GDP by 2008 due to Nato membership requirements; the need to finance the infrastructure.

The envisaged reduction of the general government's deficit will be achieved by a gradual decline in expenditure to GDP ratio in 2005 and 2006. The share of government revenues in GDP will decline during 2005-2006 as a result of the tax reform adopted in 2004 and implemented as of January 1st, 2005 and of the adverse effect on VAT revenue collection of replacing border controls with the EU customs system. In 2007 the share of revenues in GDP is expected to increase as a result of the positive net budgetary effect of the new financial perspective. The tax reform that begins to be implemented in 2005 aims at: reducing the direct tax burden on labor; streamlining the tax reliefs in corporate income tax and spur investment in R&D as well as unburden lower income taxpayers. Changes in the area of taxation will be accompanied by a more efficient administration of public taxes. The new government is also committed to improve the quality of fiscal policy by redirecting expenditures towards those programs that have positive impact on development (expenditure restructuring) while adjusting total expenditure in order to reduce government deficits (expenditure reduction).

3.2. Overview of public finances

3.2.1. General government balance

In 2003 the parliament approved the two annual budgets for 2004 and 2005. Both budgets envisaged a shortfall in VAT revenue collection. In 2004 a one-off shortfall of VAT revenue of about 0,2% of GDP resulting from replacing border controls by the European declaration system was envisaged and for the period 2005-2007 a gradual decrease in the efficiency of revenue collection of about 0,3% of GDP is foreseen. The envisaged reduction in the collection of VAT revenues is perceived as an indirect impact of EU accession.

The 2004 budget was framed under a considerable degree of uncertainty related to VAT revenue collection due to the one-off shortfall. By the end of the third quarter the estimated budget outturn indicated that the VAT shortfall was going to be higher than expected and on the other hand the withdrawals of funds from the EU budget were considerably below pre-accession expectations. As a consequence, the government restricted the assumption of new commitments (see Box 1). This measure and the changes in macroeconomic environment resulted in a general government deficit of 2.1% of GDP in 2004 (see Table 3.1). This figure takes into account the inclusion of two previously extrabudgetary funds within the general government as reported in the September EDP (Box 3).

Box 3. Revison of the institutional classification of the general government and impact on general government balance

Following a joint revision with Eurostat pertaining the institutional coverage of general government two public funds, the Capital Fund (KAD) and the Slovene Restitution Fund (SOD) have been included within the general government sector. KAD manages assets earmarked for financing pension obligations of Pension Fund (ZPIZ), the government pay-as-you go pension system. SOD is in charge of providing for de-nationalization claims and war damages.

The financial activity of KAD had a neutral or positive impact on the government balances. SOD on the other hand has been recording deficits since its establishment in 1993. In the years 2002 and 2003 SOD's deficits pertaining restitution of nationalized property and compensation for war damages was 0.2%. As a consequence of SOD's deficit the updated general government deficit and debt figures presented in September EDP notification and in this update have been reviewed upwards for every year by 0.2% for the period 2004-2007.

Other changes in institutional coverage of the general government sector, such as the exclusion of pharmacies, the homes for the elderly and student dorms have had a minor effect on the budget figures.

As already stated, the new government will present a supplementary budget for 2005 taking into account the revised revenue forecasts as well as a review of the composition of expenditure in line with the latest developments and its own priorities but the deficit figure will not exceed the already approved level. Hence, the general government deficit in 2005 including the activity of the three funds will not exceed 2.1% of GDP.

Table 3.1: General government budgetary developments

% of GDP	ESA Code	2003	2004	2005	2006	2007
Net Lending (B9) by sub-sectors						
1. General government	S13	-2.0	-2.1	-2.1	-1.8	-1.1
2. Central government	S1311	-1.9	-2.0	-2.1	-1.8	-1.2
3. State government	S1312					
4. Local government	S1313	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S1314	-0.1	-0.1	0.1	0.0	0.1
General government (S13)						
6. Total receipts	ESA	46.2	46.1	46.0	45.6	46.3
7. Total expenditures	ESA	48.2	48.2	48.0	47.4	47.4
8. Budget balance	B9	-2.0	-2.1	-2.1	-1.8	-1.1
9. Net interest payments		1.5	1.5	1.5	1.5	1.4
10. Primary balance		-0.5	-0.6	-0.6	-0.3	0.3
Components of revenues						
11. Taxes	D2+D5	25.2	25.0	24.5	24.4	24.4
12. Social contributions	D61	15.2	14.6	14.5	14.2	14.2
13. Interest income	D41	0,6	0.4	0,3	0,2	0,2
14. Other		5,8	6.1	7,0	6,9	7,7
15 Total receipts	ESA	46.2	46.1	46.0	45.6	46.3
Components of expenditures						
16. Collective consumption	P32	8.4	8.3	8.3	8.1	7.9
17. Social transfers in kind	D63	2.1	2.1	2.1	2.0	2.0
18. Social transfers other than in kind	D62	17.2	17.0	16.7	16.4	16.1
19. Interest payments	D41	2.1	1.9	1.8	1.7	1.6
20. Subsidies	D3	1.5	1.4	1.5	1.7	1.9
21. Gross fixed capital formation	P51	2.8	2.9	2.9	2.8	3.0
22. Other*		14.2	14.5	14.8	14.7	15.0
23. Total expenditures	ESA	48.2	48.2	48.0	47.4	47.4

Source: Figures for 2003 SORS. Figures for 2004-2007 MF RS.
Notes: * Includes wages, social security contributions and expenditure on goods and services in non-profit general government institutions in the area of education, healthcare, social security and culture. In 2003, these accounted for 84% (11.2% GDP) of all expenditures under "Other". The remainder is accounted for by payments to the EU budget, transfers to non-profit organizations, investment transfers outside the general government, reserves and current transfers abroad.

For the years 2006 and 2007, the general government's deficit figures as percentage of GDP will be 1.8 % and 1.1% respectively. Over the period 2005-2007, total government revenues as percentage of GDP are first expected to decline to 45.6% by 2006, as a result of tax reform (see Tables 3.1 and 3.3) and impact of EU accession, and then will pick up in 2007 (46.3%) in line with Slovenia's expectations about the EU new financial perspective 2007-2013 (NFP). The revenue dynamics will be underpinned by the relative slow growth of wages and consequently relatively lower payment of social security contributions (Table 3.1) Expenditure as percentage of GDP will only decline gradually in the next three years from 48.2% in 2004 to 47.4% in 2007. As explained in section 3.4, the path of expenditure reduction reflects only partially the expenditure restructuring effort. It is worth noticing that total expenditures in 2007 include the amount of expenditures to be financed with sources of the NFP, which was not the case in the previous Convergence Program presented in May 2004. In this regard, the working assumption is that after 2007 the expected increase in receipts from the EU budget will exceed the expected increase in payments into the EU budget, thus Slovenia's net budgetary position would improve from about 0.4% of GDP in 2006 to 0.8% of GDP in 2007 (Box 4 and Table 3.2).

Box 4. Financial flows between the Slovenian and EU budget

The fiscal projections for the period 2004-07 take into account the impact of financial flows between the EU and the Slovene budget. While actual data is used for 2004, the following assumptions are applied thereafter:

1) For 2005, the 2005 budget and transfer of unused funds from 2004 are taken into account.

2) From 2007 onwards the new member states will not be eligible anymore for pre-accession aid and lump-sum payments.

3) In line with the principle of solidarity, Slovenia expects that in the period of the next financial perspective, the EU will continue to finance costs of the common external border.

4) The amount of structural and cohesion funds for 2007 includes the drawing of funds allocated for current and next financial perspective.

5) The amount of funds for common agricultural policy in 2007 includes drawing of unused funds, allocated for 2006, and a proportion of funds allocated for 2007 (NFP).

6) EU expenditure for growth and employment (Lisbon strategy) will most likely not be the revenue of the national budget, and can therefore not be taken into account.

7) The contribution to the EU budget in 2007, calculation is made on the basis of the Commission's proposal concerning the size of the future budget appropriations (1.14% GNI of EU-27).

Table 3.2: Budgetary effects of EU accession

Current prices, mio EUR	2004		2005		2006		2007	
	EUR	**% BDP**	**EUR**	**% BDP**	**EUR**	**% BDP**	**EUR**	**% BDP**
PRE-ACCESSION AID	36.5	0.2	40.0	0.1	30.3	0.1	0.0	0.0
1. AGRICULTURE	23.0	0.1	109.9	0.4	162.3	0.6	254.8	0.8
1a - Common Agricultural Policy	0.5	0.0	40.1	0.1	57.1	0.2	66.9	0.2
Market measures	0.5	0.0	15.5	0.1	22.6	0.1	25.0	0.1
Direct payments	0.0	0.0	24.6	0.1	34.5	0.1	41.9	0.1
1b - Rural development (RD)	23.0	0.1	69.8	0.3	105.2	0.4	187.9	0.6
2. STRUCTURAL ACTIONS	0.0	0.0	143.4	0.5	137.5	0.5	374.5	1.2
Structural funds (SF)	0.0	0.0	89.9	0.3	102.6	0.4	250.6	0.8
Cohesion fund (CF)	0.0	0.0	53.4	0.2	35.0	0.1	123.9	0.4
3. INTERNAL POLICIES	38.5	0.2	43.6	0.2	48.0	0.2	51.3	0.2
Existing policies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Institutions building	0.0	0.0	4.4	0.0	7.1	0.0	9.0	0.0
Schengen border	38.5	0.2	39.2	0.1	40.9	0.1	42.3	0.1
4. LUMP-SUM PAYMENTS	105.3	0.4	94.6	0.3	62.0	0.2	0.0	0.0
Cash-flow lump-sum	72.6	0.3	20.3	0.1	20.7	0.1	0.0	0.0
Budget compensation	32.7	0.1	74.3	0.3	41.4	0.1	0.0	0.0
A. TOTAL RECEIPTS FROM EU BUDGET	**203.3**	**0.8**	**431.5**	**1.6**	**440.2**	**1.5**	**680.6**	**2.1**
1. Traditional own resources	12.7	0.1	31.8	0.1	33.6	0.1	34.3	0.1
2. VAT resource	25.4	0.1	38.0	0.1	40.5	0.1	47.2	0.2
3. GNI resource	117.5	0.5	215.4	0.8	229.8	0.8	274.0	0.9
4. UK rebate	16.3	0.1	29.3	0.1	31.3	0.1	44.1	0.1
B. TOTAL PAYMENTS TO THE EU BUDGET	**171.9**	**0.7**	**314.5**	**1.1**	**335.1**	**1.1**	**399.7**	**1.3**
C. N E T POSITION	**31.4**	**0.2**	**117.0**	**0.4**	**105.0**	**0.4**	**280.9**	**0.8**

Source: MFRS

3.2.2. Balance by sub-sectors of general government

The central government deficit (state budget, extrabudgetary funds, agencies and other entities at the level of general government) in 2003 was 1.9% of GDP. The deficit in 2004 will be 2.0% of GDP and it will gradually decline to 1.2% of GDP in 2007 (Table 3.1) through the implementation of the Government's expenditure policy defined in next section.

The two compulsory social insurance funds, the Pensions and Disability Insurance Fund (Pension Fund) and Health Insurance Fund (Health Fund) will operate without deficits.

The Pensions Fund's balance, including central government transfers to cover the difference between original revenues of the Pension Fund and total expenditure for pension and disability insurance was in surplus of 0.05% of GDP in 2004. It will continue to operate with a slight surplus in 2005-2007 (0.08% of GDP). The expected surplus will enable the pension fund to gradually repay in full until 2007 the debt accumulated in previous years. The expenditure dynamics will be governed during 2005-2007 by the implementation of the pension reform including current pension indexation formula. Nevertheless, the new government is committed to review the formula and at least decrease the fall in real terms vis-à-vis the average wages. The expected adjustment is subordinated to the actual budgetary possibilities and fiscal targets presented in this Convergence Program.

In 2003 the Health Fund recorded a slight deficit amounting to 0.2% of GDP. The deficit in 2004 will be also 0.2% of GDP slightly lower than planned. In subsequent years the deficit will be practically eliminated. Among the key measures underlying the envisaged development are the central government's assumption of the debt incurred by the Fund incurred up to 2004 (about SIT 29 bn). Other important determinants contributing to the Fund's close-to-balance budget are the implementation of measures such as the use of generics rather than original medicines, and the introduction of a reference price list for medicines which resulted in significant savings. A slower than foreseen increase in the number of health personnel (doctors and nurses) will also contribute to keep the Health Fund budget in balance.

The combined budgets of all 193 local governments in which central government transfers are included, were in balance in 2003. This position will be maintained throughout the period 2004-2007, eventhough, the central government budget will have to transfer resources to the local governments in order to cover the expected losses of revenue due to changes in the personal income tax in 2005 and 2006.

Other extra-budgetary public funds and agencies at the general government level recorded a deficit amounting 0.4% of GDP in 2004.[11] The combined deficit of these entities will be reduced to 0.1% of GDP in 2005 and will be gradually phased out to reach a balance in 2007.

3.3. General government revenues policy

Restructuring of government revenues, a commitment of the new government will continue in the future, particularly by means of further relative reductions of direct tax burden on labor, as well as additional adjustments in the corporate income tax. These changes will be accompanied by specific measures to increase the efficiency in the tax administration area. Total revenue is expected to decline slightly during 2005-2006 and increase in 2007 only as a result of the envisaged revenues from the NFP.

The new Personal Income Tax Act and Corporate Income Tax Act were adopted in 2004. However, its full implementation started with January 1st, 2005. The Personal Income Tax Act reduces primarily the burden for lower income taxpayers. In addition, the minimum threshold for payroll taxes was raised to lower the tax burden of the lowest income group. The combined effect of changes in personal income and payroll taxes is expected to enhance low income earners' employment perspectives.

[11] In line with ESA 95 methodology and consultations with Eurostat there were 14 extrabudgetary public funds (including KAD and SOD) and 7 public agencies operating in Slovenia in 2004.

The new personal income tax regime aims at equalizing the tax burden on all sources of income and is based on the principle of equal tax treatment for all taxpayers with approximately equal incomes. The new Income Tax Act lays down five tax brackets, with rates ranging from 16% to 50%.

The Corporate Income Tax Act expands the tax base through a more precise definition of taxpayers and a stricter stipulation of detailed conditions for exemptions for those engaged in nonprofit activities. Tax incentives are better targeted and geared towards fostering competitiveness (streamlining the general relief for investment in fixed assets and introducing a relief for R&D equipment). The new Act introduced more detailed arrangements for determining the tax base and tax treatment of transfer prices, interest payments among related persons, favorable tax treatment of reorganisations (transfer of activities, exchange of capital shares, mergers, etc). Similarly, the number of types of income taxed at the source is expanded. Although, the current tax 25% tax rate is retained the effective tax rate is expected to increase from its current 12% to 17%. The expected increased revenues from this source will at least partially make up for the reduced revenues from income tax.

A new Real Estate Tax Act, planned for adoption during the program period, will establish a new system of taxation on real estate to replace the existing system (compensation for the use of building land and property tax), based on completed and updated real-estate records. The tax burden is not expected to differ fundamentally from the current one on such real estate. The budget resources in this area would remain roughly the same.

Further reductions of payroll taxes are envisaged to enhance competitiveness of the economy and will be linked to the new Social Agreement for the years 2006 and beyond.

Over the coming years, the Government does not envisage changes in the level of social-security contribution rates. However, the tax base for social security contributions of some groups will be broadened.

The Government is not planning significant changes in indirect taxes (primarily VAT and excise duties) in next years. So far, revisions to the VAT Act have merely harmonised Slovenia's VAT system with the one of the EU without significant fiscal consequences. The government will continue to adjust excise duties in accordance with the obligations accepted in pre-accession negotiations. Excise duties on liquid fuels will continue to be adjusted to buffer the high volatility of oil price changes and especially their secondary effects.

The combined cumulative effect of the changes in tax system on total revenue compared to the base year in 2004 will be negative of about SIT 7.5 Bn from 2007 onwards (Table 3.3). The effect on government revenue will be particularly negative in 2005 and 2006 of about 0.3% of GDP and 0.4% of GDP respectively. The change in corporate income tax will bring additional revenue while personal income tax and payroll tax will reduce tax revenue. Besides the net impact on the level of overall general government revenue, the changes in the tax system, particularly in the personal income tax, will affect the allocation of revenue among different sectors of the general government. The impact of the changes in personal income tax will be felt on all levels of the general government particularly on the state budget.

Table 3.3: Cumulative impact of tax reform

SIT billion	2005	2006	2007
1. Personal income tax	-24.4	-32.8	-32.8
2. Corporate income tax	8	13	32
3. Rise in minimum threshold for pay roll tax	-6.7	-6.7	-6.7
4. Total	**-23.1**	**-26.5**	**-7.5**

Source: MFRS.

3.4. General government expenditure policy

The measures aimed at restructuring and reducing the deficit concern mainly the structural deficit or the fixed part of the budget expenditure, thus enhancing the flexibility and the quality of public finances. The policy measures will affect mainly wages, social transfers and purchase of goods and services. Other policies include among others, reductions of expenditures in the Ministry of Agriculture to top up funding for common agricultural policy and a new wage system in the public sector. The combined effect of restructuring and expenditure reduction expressed as a share in GDP is 0.4% in 2004, 0.6% in 2005, 1% in 2006 and 1.3% in 2007 (Table 3.4). As a result of the expenditure policy the share of general government expenditure in GDP will gradually decline from 48.2% in 2004 to 47.4% in 2007.

Table 3.4: Quantitative effect of total budget adjustment in 2004-2007 (% of GDP)

% of GDP	2004	2005	2006	2007
Expenditure Restructuring	0.2	0.3	0.6	0.9
Expenditure Reduction	0.2	0.3	0.4	0.5
Total adjustment	**0.4**	**0.6**	**1.0**	**1.3**

Source: MFRS.

The envisaged expenditure adjustment presented in this Convergence Program foresees a decline in the share of pension expenditure in GDP (from 13.6% in 2003 to 13% in 2007) and a reduction in interest payments (from 1.9% of GDP in 2003 to 1.6% of GDP in 2007) as a result of active debt management, low interest rates and decreasing deficits. The effect of the 1999 pension reform and particularly the change in the pension indexation formula in effect since 2001 resulted in pensions growth lagging behind wage growth which has so far delivered significant savings with short and long term impact. Other parametric changes already introduced in the pay-as-you-go system will have an impact on pension expenditure in the medium term. As a result of the pension reform, the upward trend increase of pension expenditure as percentage of GDP in the last decade reverted from its peak in 2002 (13.8% of GDP). The pension reform will continue to be implemented in the future. As stated earlier, the new government is committed to review for the year 2006 the existing pension indexation formula within the macroeconomic framework and budgetary targets defined in this Convergence Program.

Wage policy will continue to be restrained. The total wage bill will slightly decline by 0.3% of GDP in the period 2004-2007. Already the real wage growth per employee in the public sector in 2004 will be lower than in 2003 (section 1.3). The wage dynamics results from various policy measures including the 2003 agreed public sector wage policy for the period 2004-2005 and for the period 2006-2007 no policy changes are foreseen, the introduction of a funded pension plan for public sector employees in 2004 and restrictions on non-selective promotions and additional employment. The restrictive employment policy foresees additional employment in the government only in the judiciary system and in activities related to security (army and police). In the period 2005-2007 the number of employees in the central government and in local governments will decline. Neither will increase the number of employees in non-profit governmental institutions (javni zavodi) except in the health care sector.

Although the implementation of the new Public Sector Salaries Act in 2004 was postponed, it is expected to be implemented in 2005 in a fiscally neutral manner. Further reduction in the relative share of labor costs will be achieved by increasing employment flexibility in the public sector, increasing efficiency in performing tasks and reducing unnecessary costs. The new government is preparing a centrally managed project for restructuring human resources in the public sector, and will adopt measures for better operation of administration in the area of internal organisation and human-resource management.

The new government is committed to deepen and speed up the process of rationalization and deindexation of social transfers. The system is increasingly oriented towards low-income groups of the population and to effectively influencing poverty reduction. The objectives in the area of social transfers are: reducing the dependency of the population on social transfers, ensuring social security through working activities, greater flexibility of the system of social transfers, and improving protection for the most socially vulnerable. The impact of rationalizing and de-indexing social transfers on the budget will be a reduction on transfers to individuals and households of about 0.9% of GDP during the period 2004-2007 (Table 3.1). Concrete measures which have already generated some results in 2004 and will contribute to achieve the objectives include: i) promotion of employment of recipients of social transfers and compensation for unemployment with the help of subsidies and other measures of employment policy; ii) elimination of unjustified accumulation of benefits; iii) upgrading information systems to enable greater transparency and oversight of the systems of social transfers; iv) amending the mechanism for adjusting social transfers so as to complete the elimination of index-linking, which began in 2004 and; v) redefining the criteria for granting individual types of social benefits.

In the area of expenditure in goods and services policy measures will also aim at rationalization and enhancement of the quality of expenditure. Total expenditure in this area will decline by 0.4% of GDP from 2004 to 2007. Concrete measures include: i) reallocation of expenditures from programs that are less effective and successful to more effective programs; ii) changing the criteria for eligibility for funds; iii) reducing the rigidity of the method of coordinating statutory expenditures and; iv) obtaining additional resources for infrastructure projects from non-public sources; and v) establishing the legal and operating framework for instituting public private partnerships (PPP). Based on analysis of the effectiveness and success of programs, those that do not provide satisfactory results will have to be abandoned.

Subsidies will continue increasing as a share in GDP from about 1.4% in 2004 to 1.9% in 2007. This increase is mainly due to agricultural subsidies which will practically triple from SIT 25 Bn to SIT 80 Bn in the same period, thereby levelling out the conditions for Slovene farmers with those from other EU Members States. Funds for other types of subsidies, used mainly for horizontal objectives will be maintained at current levels.

The policy of expenditure restructuring aims at increasing the quality of public finance in accordance with the goals of Lisbon Agenda. Priority areas include research and development, education and training, employment, entrepreneurship and competition (detailed policy measures are elaborated in section 5).

Slovenia has the highest R&D spending among the new member states (1.5% of GDP, with roughly 60% of this coming from the private sector) yet still lags behind the Lisbon targets. Funding for science and technological development has been steadily increasing. The objective is to continue progress towards Lisbon targets with appropriate policy measures such as additional tax incentives (including tax credits as proposed by the new government) that will increase the level of collaboration between research institutions and industry. These policies will enhance the establishment of knowledge-based society, and at the same time increase the competitiveness of the Slovenian economy, leading to real convergence.

Funding in the area of education and training will increase at an annual rate of 8.5% in the period 2001-2005 to a level of 4.6% of GDP in 2005. This involves not just an increase in total expenditure in these areas, but also an appropriate reallocation among individual levels of education so as to maximise the long-term effects and results. Emphasis will be given on improving the quality of higher level of education although quality will improve across all levels including the extension of primary schooling period from 8 to 9 years.

Active labor market policies will continue to increase employment of the young as well as the older population reinforcing the measures channeled through the tax system and the pension reform (increasing retirement age). The share of this type of expenditure as percentage of GDP will slightly increase from 0.35% in 2004 to 0.39% in 2007. Expenditure projections are consistent with the expected increase in the number of individuals joining the labor market and the expected reduction in unemployment.

Fostering a favorable business environment is another key priority area which includes measures aiming at reducing administrative burden and the establishment of one-stop shops. Budget resources to increase enterprise competitiveness have been steadily increasing over the years and are expected to double by 2007.

3.5. Structural balance

In line with the estimates for GDP growth, it is expected that the growth of potential GDP will remain around 3.7% in the period 2005-2007 (estimated by the production function method). Despite the continued reduction in the contribution of total factor productivity, growth in potential GDP remains primarily a consequence of the latter and of the increased contribution of capital.

Table 3.5: Cyclical developments

% of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP – real growth rate	B1g	2.5	4.0	3.8	3.9	4.0
2. Actual balance	B9	-2.0	-2.1	-2.1	-1.8	-1.1
3. Interest payments	D41	2.1	1.9	1.8	1.7	1.6
4. Potential GDP growth		3.7	3.6	3.8	3.7	3.7
5. Output gap		-1.2	-0.8	-0.8	-0.6	-0.2
6. Cyclical budgetary component		-0.7	-0.4	-0.4	-0.3	-0.1
7. Cyclical adjusted balance (2-6)		-1.3	-1.7	-1.6	-1.5	-1.0
8. Cyclical adjusted primary balance (7-3)		0.2	-0.1	-0.1	0.0	0.4

Source: MF RS.

The gradual decrease in the general government deficit over the next four years will be partially a consequence of the gradual reduction in the cyclical adjusted deficits, and ongoing expenditure restructuring. Measures on the part of public finance revenues and expenditures described in the previous chapter will contribute to a reduction in the structural portion of the public-finance deficit by approximately 0.9 percentage points in the period 2004-2007. In addition, expenditure reduction will also be influenced by an active policy of debt management. Interest payments will thus be reduced from 1.9% of GDP at the end of 2003 to 1.6% of GDP by the end of 2007.

3.6. General government debt

The outstanding amount of general government debt was SIT 1,690 Bn (29.4% of GDP at the end of 2003). The largest share (more than 95%) of the total represents the central government debt. The shares of social insurance funds' debt and local communities' debt are 2.5% and 1% respectively. The reviewed debt figure includes the activity of the two extrabudgetary funds included within general government in September 2004. The differences between the figures of the size of the debt compared with previous convergence program are a result of including additional three entities within the sector of general government in September 2004. Differences compared to the September EDP report are due to revision of GDP growth.

Due to the undeveloped and small financial market and high inflation, until 2000 the central government borrowed on the domestic market primarily through index-linked instruments (mainly inflation index-linked, while instruments were to a lesser extent indexed to the exchange rate first of the Deutschmark and later the Euro). In 2000, the Government took the first step in the gradual transition towards the use of long-term nominal financing instruments by starting to issue long-term instruments and hiring loans, both with variable interest rates. The variable part of interest rates was still linked to inflation. Through the process of gradual transition from the use of inflation-indexed instruments to the use of nominal instruments of financing, the state began to reduce the sensitivity of its debt to inflation trends. In 2002, the central government for the first time on the domestic market issued long-term nominal three-year tolar bonds with a fixed interest rate. In 2003, the gradual transition towards the use of nominal instruments was completed with the issuing of the first five- and ten-year tolar bonds with nominal, fixed interest rates. The issuing of the first ten-year tolar nominal bonds with fixed interest rates enabled verification of compliance with the Maastricht long-term interest rate criterion. During 2004 – and as expected in 2005 – the central government continued borrowing in the domestic market by issuing tolar securities with nominal, fixed interest rates.

General government debt is estimated to be 30.2% of GDP at the end of 2004. It is expected to grow until 2006 to reach a level of 30.9% of GDP and then will start to decline. In 2007, the debt as percentage of GDP will be 29.7%. Debt dynamics are explained primarily due to the central government deficit. In 2005 the central government is expected to take over the debt of the Health Fund which will have a positive impact on the future balance of the Fund. Similarly, it is expected to take over the debt incurred by nonprofit public healthcare institutions (javni zavodi). The total amount of assumed debt will not exceed SIT 40 Bn. General government debt is expected to decline gradually after 2006.

Table 3.6: General government-debt developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		29.4	30.2	30.7	30.9	29.7
Change in gross debt		-0.1	0.8	0.5	0.2	-1.2
Contributions to change in gross debt						
Primary balance		0.5	0.6	0.6	0.3	-0.3
Net interest payments	D41	1.5	1.5	1.5	1.5	1.4
Nominal GDP growth	B1g	-2.2	-2.1	-2.0	-1.9	-2.0
Other factors influencing the debt ratio		0.1	0.8	0.4	0.3	-0.3
p.m. Implicit interest rate on debt		6.7	6	5.3	5.1	4.8

Source: MF RS.

The general government debt is relatively low compared to other EU member states. Its repayment profile is predominantly long-term and spread evenly over time. In addition, the bulk of the central government external debt is denominated in Euros, and repayment of principal will fall due mainly after the adoption of the Euro.

3.7. Contingent liabilities

3.7.1. Legal environment

The EU rules defined in the Protocol on the excessive deficit procedures currently do not include any rules that would address contingent and implicit liabilities. Neither has the recent policy debate resulted in commonly agreed or even proposed criteria and defined guidelines on inclusion of contingent liabilities in the long-term sustainability assessments on fiscal and overall stability of the countries, evaluated through convergence programs. Nevertheless, the Slovenian legal framework already since 1999 provides for a comprehensive set up for monitoring of contingent liabilities potentially arising from the state guarantees as well as from broader public sector, namely liabilities arising from all the public sector borrowing and its guarantee issuance (Box 5). The existing framework very much captures the notion of government debt with respect to these types of contingent liabilities, as discussed in the recent note of EC on budgetary risks and contingent liabilities.

Box 5. Legal framework for monitoring contingent liabilities

The legal basis for borrowing and issuance of guarantees of the Republic of Slovenia is set forth in Article 149 of the Constitution of the Republic of Slovenia, stating that “The state shall only be permitted to borrow or to guarantee credit on such conditions as are determined by law”. The Law on Public Finance defines the principles of central government and municipalities' borrowing, issuance of guarantees by central government and municipalities, and size and regulations for the rest of public sector entities' borrowing.

Nominal amounts for central government borrowing, for central government guarantees and for public sector borrowing and guarantee issuance (quotas) are set in an annual Budget Execution Act. A restriction on the GDP share of public sector debt is the key element for the quotas; together with government borrowing, they represent a macroeconomic item. These restrictions also represent, inter alia, a political commitment.

The public sector is defined by the Law on Public Finance as indirect budget users, the Health Insurance Fund and Pension and Disability Fund, both for obligatory insurance, public institutes of commercial character, public companies and any other legal entity where the government has decision – making power as owner.

Procedures and conditions for borrowing and issuance of guarantees by the public entities mentioned above are defined, following the provisions of the Law on Public Finance, by the Decree on Conditions and Procedures for Public Sector Entities' Borrowing and by Instructions on Reporting on Borrowing and Debt of Public Sector Entities and Municipalities.

3.7.2. State Guarantees

In the legal system of the Republic of Slovenia a dual system for issuing guarantees was developed. A guarantee can be issued on the basis of a “special law” adopted by the parliament whereas a law is adopted for the purpose of financing a specific project (infrastructure financing, investments in power facilities, etc). Besides, guarantees can be issued on the basis of a "general law" adopted by the parliament whereas a law does not specify the issuing of a guarantee for a specific beneficiary and a specific project but merely lays down the criteria and the conditions for obtaining a guarantee and the maximum amount of guarantees issued on its basis. Such laws are adopted for supporting enterprise restructuring programs and an issuance of guarantee is subject to the EU state aid procedures and therefore each time reported to and confirmed by EU bodies. According to the Law on Public Finance the authorized person to sign the guarantee agreements is the Minister of Finance.

Compulsory elements of the laws on state guarantees are the amount of the guarantee, the maturity of the guarantee, the purpose for which the guarantee is issued, and the method (instrument/type of collateral and procedure) of enforcing a claim of the guarantor (i.e. the state) against the entity obtaining state guarantee, if a guarantee is exercised (encashment).

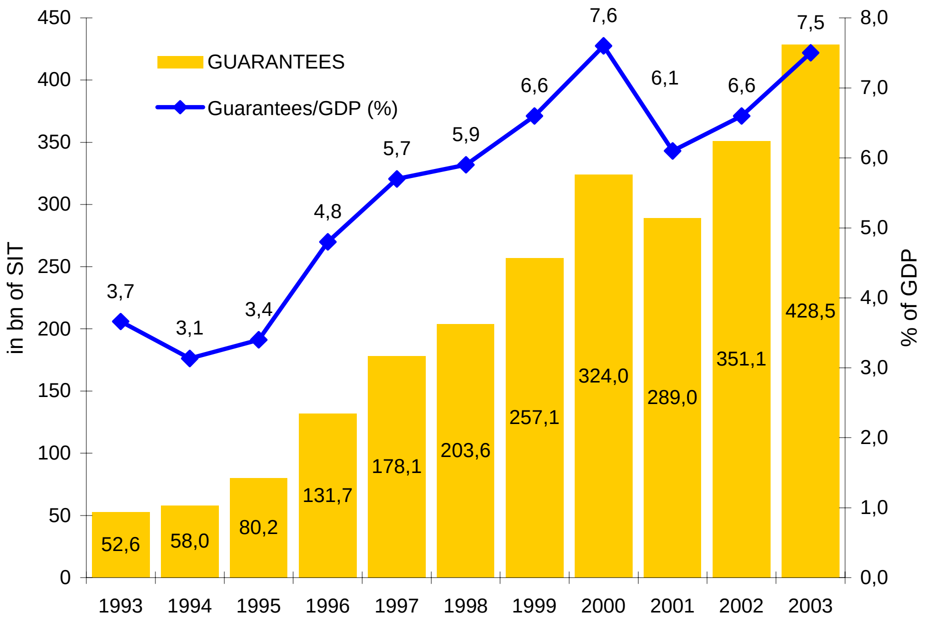
To make adjustments to the EU legislation concerning the issuing of government guarantees and connected state aid, from the year 2002 the yearly Budget Execution Act includes a clause listing the conditions private sector legal entities must fulfill when applying for a government guaranty. These are:

- a guaranty can only be issued in favor of financially sound legal entity,
- a guaranty can only be issued for up to 80% of the debtor's total liability,
- the guaranty must contain a time limit,
- a fee of no less than 0.1% of loans covered by the guaranty shall be charged.

The existing legal framework together with other regulations prescribing procedures, nominal yearly quotas, reporting etc. provides the Ministry of Finance with a complete and accurate set of data on potential liabilities arising from state guarantees. When issuing a guaranty, an adequate coverage for recovery should the guarantee be called is ensured. The budged preparation process assures the provision of yearly budget appropriations for the planned amounts of possible yearly encashment of guarantees[12]. Fiscal risks related to government guarantees are considered relatively low (see Table 3.8).

[12] Encashment of state guarantees is mainly possible only in the case of bankruptcy and liquidation of entity where reporting and other procedures allow for advance planning of occurrence of such event.

Figure 3.1: State guarantees outstanding



Source: MF, 2003 Debt Report

The outstanding amount of state guaranteed debt (withdrawn but not repaid) amounted to 7.6% of GDP at the end of 2003[13]. The majority of state guarantees are issued on the basis of "special laws" for the financing of infrastructure. The structure of outstanding guarantees at the end of 2003 by "sector of beneficiary" is seen from table below.

Table 3.7: State Guarantees by Sector of Beneficiary

Debt outstanding as per end 2003	**SIT bn**	**% GDP**
1. Central government sector entities[14]	22.1	0.5
2. Public non-financial sector entities[15]	385.5	6.7
3. Private sector entities[16]	20.9	0.4
4. Total	**428.5**	**7.6**

Source: MFRS.

The actual state service of obligations outstanding from issued state guaranties is relatively low as seen from the Table 3.8. The encashment as percentage of

[13] The drop of state guarantees outstanding 2001 to 6.1% of GDP, compared to 7.6 % of GDP in 2000 is mainly due to debt assumptions of Slovenian Railways and Slovenian Steelworks in the process of restructuring which were, when contracted, covered by government guarantees.
[14] State funds and agencies, whereas their debt is already included into reporting on central and general government debt outstanding.
[15] Railways, roads, power plants, Export Import Insurance company etc.
[16] Based on "general laws" for supporting restructuring programs and subject to the EU regulation on state aid.

outstanding guarantees is declining over years. The declining trend is result of the conclusion of the mayor real sector restructuring processes.

Table 3.8.: State Guarantees Encashment

in million SIT

Year	Outstanding guarantees per Dec. 31st	Encashment	Encashment as percentage of outstanding guarantees	Refundation in the year of encashment	Refundation as percentage of encashment
1995	83.863				
1996	131.676	3.378	4.0%	1.424	42.2%
1997	178.347	2.074	1.6%	678	32.7%
1998	202.972	2.544	1.4%	0	0.0%
1999	256.750	4.686	2.3%	485	10.4%
2000	324.049	5.897	2.3%	240	4.1%
2001	288.991	6.700	2.1%	0	0.0%
2002	351.083	4.949	1.7%	447	9.0%
2003	428.550	3.527	1.0%	8	0.2%
2004*		1.617	0.4%	138	8.5%

*As per November 30th, 2004
Source: MFRS.

3.7.3. Public Sector Debt

The total debt of the public sector entities not included within the general government and their guaranteed debt to third parties represented at the end of 2003 10.8% of GDP, compared to 10.6% GDP at the end of 2002. It refers mainly to the debt of public non-financial sector entities, which obtain most of their revenues from the market, related to the financing of infrastructure projects. As seen in Table 3.7 the outstanding debt of this sector represented 6.7% of GDP by the end of 2003.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

4.1. Analysis of sensitivity to changes in economic activity

Given the uncertainty in oil price trends, an alternative scenario shows the sensitivity of developments of macroeconomic aggregates to oil price changes. This calculation is based on the assumption that oil prices would rise by USD 10 per barrel relative to the baseline scenario and maintain a higher level throughout the year. Taking account of its negative impact on the world economy, such a development would slow down foreign demand by around 0.5 of a percentage point[17], which would decelerate the real growth of exports by 0.2 of a percentage point. Weaker export demand along with the higher costs of intermediate goods would have a negative impact on value added growth in manufacturing. Higher oil prices would accelerate consumer price rises by around 0.8 of a percentage point which would in turn,

[17] Estimated using the IMF's model calculation (World Economic Outlook, October 2000).

coupled with less favorable terms of international trade, have a negative impact on the real growth of domestic consumption aggregates (particularly of investment and slightly less of private consumption). The overall effect of these factors would result in around 0.3 of a percentage point lower economic growth in the year when oil prices were to increase relative to the baseline scenario assumption.

In the Convergence program of May 2004 we already identified two risks stemming from joining the EU. The first risk is the potential rapid declining of competitiveness in labor-intensive industries which would lead to lower domestic production growth and higher unemployment. The second risk lies with possible stronger growth in domestic consumption's as a consequence of the lowering of nominal interest rates after ERM2 entry, which could cause macroeconomic imbalances in external trade and inflation. The estimate in spring was that these risks were not very likely to come true, which has been confirmed by the available data on economic trends after EU entry. Nevertheless, since they cannot be excluded entirely for the time being the autumn forecast again examines their potential consequences that could surface mainly in 2005.

A rapid deterioration of competitiveness in labor-intensive industries, the decline in their exports and production would result in lower economic growth and higher unemployment compared to the baseline scenario. The overall effect of these impacts would result in about 0.4 of a percentage point lower economic growth in 2005 compared to the baseline scenario. The average number of the unemployed would in this case increase by around 4,200 compared to the baseline scenario. Our estimate is that such trends would not have an impact on price rises so that the inflation forecast can remain unchanged compared to the baseline scenario. As a result of all these factors, the general government deficit in 2005 could increase by 0.2 of a percentage point compared to the baseline scenario.

The stronger growth of domestic consumption relative to the baseline scenario (where its strengthening was already assumed) coupled with higher economic growth would undermine the external balance and boost inflationary pressures. Any greater response of domestic consumption to lower interest rates, which is still possible but less likely than the one assumed in the baseline scenario, could push up the real growth of gross fixed capital formation and private consumption in 2005. The faster growth of domestic demand would boost economic growth by around 0.5 of a percentage point in 2005. The current account deficit would widen by about 0.5% of GDP in 2004 and 1.3% of GDP in 2005. At the same time, strengthened domestic consumption would slow down the lowering of inflation (by around 0.4 of a percentage point), but this effect would not be seen before 2005. According to these assumptions, the general government deficit in 2005 would narrow by 0.4 of a percentage point compared to the baseline scenario.

The outstanding general government debt is relatively insensitive to changes in inflation, exchange rate and the level of GDP. The cost of servicing existing debt and repayment of existing credits and securities in 2004 was found to be relatively insensitive to economic shocks. Were the EUR/SIT exchange rate to increase in 2004 by SIT 36, and the USD/SIT exchange rate by SIT 29, this would increase interest by 0.07% of GDP, and debt level by 0.01% of GDP. If inflation increased by 3.8 percentage points above the planned level in 2004, this would mean increased interest costs of 1.22% of GDP and would have negligible impact on the debt level. The combined effects of deteriorating exchange rates (depreciation) and higher inflation would be 1.29% of GDP on interest and 0.03% of GDP on debt level.

Table 4.1: Sensitivity of interest payments and debt repayments of the general government to changes in certain macroeconomic aggregates for two standard estimation errors

% GDP	2005		2006		2007	
	Interest	Debt	Interest	Debt	Interest	Debt
Change in exchange rates (EUR/SIT and USD/SIT)	0.07	0.01	0.06	0.01	0.01	0.00
Change in inflation	1.22	0.01	-0.00	-0.00	-0.00	-0.00
Change in exchange rates and inflation	1.29	0.03	0.06	0.01	0.01	0.00

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. This is primarily a consequence of the currency structure and the structure of debt instruments. The bulk of national debt is denominated in tolars and euro, with other currencies representing only around 1.5% of the total. In terms of the structure of instruments, fixed-rate debt already represents around 60% of the total debt, while the proportion of index-linked debt (to inflation and/or exchange rates) has fallen to around 14% of the total general government debt.

4.2. Comparison with the Convergence Program (May 2004)

The projections for 2004 and 2005 are slightly higher than the CP May 2004 forecasts primarily as a result of higher growth of exports and slightly higher positive contribution of changes in stocks to the growth of GDP. The expected GDP growth rates for the period 2006-2007 have been revised slightly upwards.

Table 4.2: Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
1. GDP growth /constant prices)					
Previous update (spring 2004)	2.3	3.6	3.7	3.8	3.9
Latest update	2.5	4	3.8	3.9	4
Difference	0.2	0.4	0.1	0.1	0.1
2. Actual balance					
Previous update (spring 2004)	-1.8	-1.9	-1.8	-1.5	-0.9
Latest update	-2.0	-2.1	-2.1	-1.8	-1.1
Difference	-0.2	-0.2	-0.3	-0.3	-0.2
3. Gross debt					
Previous update (spring 2004)	28.6	29.1	29.5	29.4	28.4
Latest update	29.4	30.2	30.7	30.9	29.7
Difference	0.8	1.1	1.2	1.5	1.3

Source: IMAD, SORS, MF RS.

The main difference between this and previous Convergence Program concerning actual general government's balance figure is due to the inclusion of the activities of two extra-budgetary funds within the general government and the change in the composition of expenditures and revenues in 2004. In the case of debt dynamics the difference mainly results from including the two funds within the scope of the general government (September EDP notification) and from slightly higher deficits.

In the spring update the 2007 budget outcome did not include the expected receipts from NFP, which implied that expenditure related to structural funds and cohesion funds were not included and as a result the share of expenditures in GDP was underestimated. This update includes those receipts.

5. STRUCTURAL POLICY

Structural reforms, which will improve the economy's competitiveness and increase its adaptability, are essential for Slovenia's effective integration into the EU. Positive developments have been recorded in the past year, in line with the measures adopted by Slovenia in response to the recommendations of the BEPGs and Employment guidelines.

The adopted national budgets for 2004 and 2005 increased the funds allocated for purposes which will contribute most to economic growth and real convergence[18]: (i) science and technological development by 24.4%; (ii) promotion and support of economic activities by 62.4%; (iii) infrastructure by 16.2%; (iv) education by 10.2%; (v) active employment policy by 19.9%.

5.1. Fostering entrepreneurship and competitiveness

The crucial reforms promoting enterprises and their competitiveness are those that focus on improving the effectiveness of the institutional regulatory framework and public administration alongside with measures to improve the business environment. Reforms are being implemented in all these areas and progress in improving competitiveness has already been recorded. The new government is committed to deepen and accelerate this process.

In 2004, Slovenia has continued implementing the Program of Measures to Promote Entrepreneurship and Competitiveness 2002-2006. Given the importance of entrepreneurship and SME's to the creation of new jobs, two new Acts to improve the business environment were adopted[19]. Certain measures to remove administrative barriers were also adopted in the field of public administration. These include measures in human resources management (systematic monitoring of working and professional qualities and work assessment as conditions for promotion), formal conditions for a higher efficiency of administrative procedures and better accessibility of administrative services to the users.

[18] The figures refer to the 2004 budget compared with 2003.
[19] Entrepreneurship Environment Support Act and Act on Revisions and Amendments of the Small Business Act

Table 5.1: State budget financing of initiatives related to business environment

Billion SIT	2004	2005	2006	2007
Entrepreneurship and business environment	18.0	18.9	21.3	31.3

Source MFRS.

The Entrepreneurship Environment Support Act is an important step forward in establishing an entrepreneur-friendly environment. By granting public concessions for the provision of services and facilitating connections among institutions, the new Act provides for strengthening of the service network that supports entrepreneurs. This will increase the transparency and efficiency of government investments in the field of fostering entrepreneurship. Establishing the institutions dealing with innovative environment, technological parks, incubators and technological centers further enhance business environment. The Government has been supporting such activities through public tenders and incentives for promoting joint development projects[20]. The Act also laid down the establishment of the operating framework needed for an efficient use of structural funds and the basis for the use of funding from the structural funds.

The Act amending the Small Business Act has liberalised the small business sector in those areas that guarantee equal conditions (terms) to the small businesses on the common EU market. The new act stipulates that the craftsman's license may be granted to anybody who has finished at least higher vocational education in the appropriate program and has at least three years of experience. There are no more qualification conditions for engaging in similar crafts. Furthermore the act outlines the basis for determining the membership fee and an indicative structure of the Chamber's bodies. The latter should contribute to a more representative presentation of the small business sector. Currently, regulatory decrees are being drafted, aimed also at the elimination of unnecessary administrative barriers.

One of the instruments for the promotion of entrepreneurship is strengthening the role of the Public Fund for Development of the Small Business Sector, which with the existing funds of EUR 41.7 million in the period 1996 – 2002, supported about 200 projects annually on average in the amount close to EUR 29.2 million and thus provided for over 500 new jobs. By developing new services, guarantees, starting capital and risk capital for enterprises, the financial potential of the Fund will increase in the future in synergy with other financial institutions (banks, international financial institutions, funds). According to the Single Programming Document, structural policy funding is earmarked also for co-financing instruments (guarantees and premiums) to promote investments into small and medium-size enterprises that are carried out by the Public Fund for Development of the Small Business Sector. The new government will assess the effectivness of this program and, if necessary, propose the corresponding amendments.

Another vital measure for the creation of a business-friendly environment is the establishment of the One-Stop-Shop system (the VEM system). The building of the system is progressing rapidly, as the first two elements - info point and support point

[20] In 2003 the state supported three technology parks, two incubators, 28 technological centers, 11 clusters, 4 technological networks.

- have already been put in place. The registration point in the VEM project has started to be implemented and will make it possible to register an enterprise in just one state institution. After its completion, the VEM project will enable the registration of an enterprise within 14 days.

Public infrastructure and utilities as well as related services represent an important element of entrepreneurship promotion and active industrial policy. The use of structural funds in public infrastructure and services will ensure the synergies between public and private investment in the priority areas - development of innovative environment, promotion of entrepreneurship and also tourism development. Given the importance of suitable business locations for investment promotion, the first call for funding from structural funds for renewal, modernisation and construction of necessary infrastructure in business zones was held in 2004. The new government is currently preparing a law that will introduce in Slovenia a contemporary up-to-date Private Public Partnership scheme. Although its effects will not fully materialize during the program period, its prompt implementation is considered as a key signal to all economic agents, foreign and domestic, about the direction the new government intends to follow.

5.2. Research and development

Expenditure on research and development (R&D) relative to GDP (1.53% of GDP in 2002) is at a lower level than the EU average, however it is the highest among the new member states. In the structure of funding R&D in 2002, the business sector contributed 60%. The structure of researchers (in FTE[21]) according to the sectors of employment in Slovenia compared to the EU average shows a lower level of researchers in the business sector (2002: 34.9%) compared to the higher percentage in governmental and the higher education research sectors (2002: government – 32.2%, higher education – 29.4%). Nevertheless, the Slovenian R&D community efficiently participates in the European research area, in the COST Program and in the industrial research program EUREKA.

Several measures have been adopted in the past year to strengthen the R&D activity. The measures included an increase in the investment of public funding for R&D, which particularly increased the investment of public funding in applied research and targeted research projects[22], an increase of public funding for the creation of a stimulating environment for investment in R&D by the private sector, and measures for the transfer of knowledge from public research institutions to the private sector. The new government intends to strengthen all activities in this area, in particular, plans to introduce a tax credit scheme that will give the private sector a major say in the allocation of resources.

[21] Full time equivalent.
[22] There is also a new program of targeted research projects in the area of defence and security, adopted at the beginning of 2004.

Table 5.2: State budget financing of initiatives for research and development

Billion SIT	**2004**	**2005**	**2006**	**2007**
Reasearch and development	39.4	38.6	39.9	42.7

Source: MFRS

In 2004, Slovenia continued to set up the institutional framework for R&D. The Council for Science and Technology based on a partnership between the business and the public sectors was established, and it has already adopted some operative decisions concerning the priorities of future research funding. Two agencies have been set up, one in the field of research activity and one in the field of technological development, with the role of carrying out professional, research and executive tasks relating to the implementation of the new National Research and Development Program. The preparation of this program, which will among other things determine the policy and priority orientations of research and technological development in Slovenia in the next 5-year period, continues.

The cooperation between industry and the research community was further strengthened with the decision to finance (within the European Structural Regional Fund) the establishment of 8 to 9 centers of excellence in priority areas, intended to connect institutions of knowledge and the leading industrial subjects, and a program of financing the purchase of research and laboratory equipment in public research institutions.

Regarding corporate investment in R&D, a reduction of taxes amounting to 10% of the invested amount in equipment and an additional reduction of taxes amounting to 10% of the invested amount in equipment for research and technological development was introduced. A tax relief for the employment of PhDs in companies will be also introduced, with a decrease in taxes amounting to 30% of salaries of newly-employed PhDs for the first 12 months of their employment.

5.3. Labor market

The slow economic growth in the year 2003 had an affect on labor market trends. As evidenced by the labor force survey, the rate of employment decreased for the second year in a row by 0.8% and it was 62.6% in 2003, slightly behind the EU-15 average. The employment rate of older workers in Slovenia remains low (23.5% in 2003) and is among the lowest in the EU and it is largely the results of early retirements in the first years of the transition. However, in 2004 it has already increased. The unemployment rate is stagnating and remains below the EU average. Structural unemployment problems regarding certain target groups still remain inspite the progress over the past two years. Structural unemployment is characterised by a large share of long-term unemployed, older unemployed persons, first-time jobseekers, young (especially women) and unskilled unemployed (unskilled unemployed are very often also long-term unemployed). However, the long-term unemployment rate is Slovenia is below EU-25 average. It should also be noted that since 2003 regional differences began to narrow and the unemployment rates of people with special needs are decreasing.

In September 2004, Slovenia presented to the European Commission the National Employment Action Plan 2004 (NAP 2004), which is based on the strategic objectives of the National Program for the Development of the Labor Market and Employment until the year 2006[23] as well as the European Employment Strategy (EES)[24]. Slovenia has addressed the EU recommendations concerning employment policies in the framework of EES Guidelines (Guideline 1) through 10 active employment measures which include assistance with planning a career path and seeking employment, a jobseeking club, job testing, advanced and basic training programs, Program 10.000+ for education and the acquisition of national occupational qualifications and certification for unemployed persons, work-place training, encouraging new employment of first-time jobseekers, local Public Works employment programs, project learning for young adults, encouraging the mobility of unemployed persons, and the implementation of the Act on the Work-Related Rehabilitation and Employment of People with Disabilities, which lays down work-related therapy as a planned individual right of people with disabilities.

In 2004, with the objective to increase employment and to additionally encourage the employment of target groups, three special measures directed at employers and thus at stimulating demand for the labor force were implemented: (i) exempting the employer from paying social contributions upon employing an unemployed person older than 55 years of age, (ii) encouraging new employment of long-term unemployed persons who are recipients of monetary social transfers through lump sum subsidies, (iii) exempting employers from tax payment salaries paid and reimbursing them for social contributions when employing unemployed persons with higher education.

The amendment to the Payroll Tax Act raising the taxable threshold from 49% to 62% of the average salary[25], eased the burden on both employers and employees, particularly in labor-intensive industries where salaries are the lowest.

The reform of the pension system enacted in 1999 is still being.implemented.[26] Starting 2001 it was supplemented with a change in the pension indexation formula to approximately wage minus 0.5%. The reform process will be completed by 2025. So far the average age of retirement has increased gradually for men from 58 years and 2 months in 1999 to 59 years and 11 months in 2003 and for women from 54 years and 10 months in 1999 to 55 years and 8 months. The ratio of the average old-pension to the average wage fell from 75.8% in 1999 to 71.1% in 2003. The effects of

[23] The National Program for the Development of the Labor Market and Employment until the Year 2006 was adopted before the adoption of the new guidelines of the EES, therefore some of the objectives of the NAP for the year 2004 are different than previously envisaged.

[24] NAP 2004 is in conformity with the draft Strategy for the Development of Slovenia until the year 2013, which is currently in public debate.

[25] The taxable minimum has been raised from SIT 130,000 (EUR 542) to SIT 165,000 (EUR 688).

[26] The main changes in the public pension system include a gradual increase in the exit age from the labor market (to 63 for men and 61 for women), an increase in the reference period for calculating the pension base, the possibility of accumulating annual accrual rates after the pension qualifying period has been attained, additional rises and cuts in pensions for early or late retirement etc. The second part of the reform involves systematic changes, as the reform introduced the possibility of a second pillar voluntary pension insurance financed by premiums of employees, employers or both.

the pension reform can also be seen in public finances as the share of pension expenditure relative to GDP fell to 11.18% in 2003 (from 11.38% in 1999). The reform also introduced the possibility of voluntary pension insurance. More than a half of the active population is now voluntary pension insured and the volume of premiums collected by pension funds has been on the increase.

5.4. Education and training

The education system has developed significantly in the past years with the stronger involvement of the younger population and adults in secondary and post-secondary education and training (including the increasing range of lifelong activities), and the educational attainment of the population is thus being improved. The educational attainment could be additionally increased by intensified involvement of the younger population in tertiary education with a reduction of early school leavers and shorter duration of tertiary education. The participation of adults aged between 25 and 64 in education (lifelong learning activities) reached 9.1% in 2002, which ranks Slovenia above the EU average. However, in terms of the share of adults with tertiary education, Slovenia still lags behind the EU, and the gap has even increased in the past year.

Slovenia has developed schemes and adopted numerous measures in order to improve the national education and training systems. Two new acts[27] have been adopted in 2004, which should contribute to the creation of a stimulative formal basis for the intensification of the activities that Slovenia is implementing within the framework of the Bologna and Brugge-Copenhegen process in tertiary education and training. In accordance with the Bologna Declaration, the modernisation and development of education programs continues at all levels, including the post-graduate level.

Measures that support national policies in the field of education and training are: (i) teacher training, in particular, teachers of secondary and upper-secondary vocational schools, trainers, mentors/tutors of practical in-company and on-the job training, etc. (with focus on acquisition of new key competences; ICT, learning to learn, social skills, vocational guidance, entrepreneurship, foreign languages); (ii) modernisation and development of education and training programs supply, including the development of a large range of short, tailor-made formal and informal training programs for adults, with special emphasis on ICT, distance learning multimedia packages and the development of the certificate system; (iii) further extension of local/regional centers of lifelong learning aimed at strengthening access to education and training; (iv) vocational guidance and counselling of youth and adults, especially women with uncompleted schooling; (v) the extension of the model of quality assurance system on the principle of self-evaluation, with special emphasis on adult education and vocational education and training.

Basic efforts in the field of education and training are therefore aimed at intensifying the implementation of lifelong learning as the basic European instrument to ensure

[27] Act amending the Law on Higher Education and the Post-Secondary Education Act

quality of education, educational attainment as well as the increase in the employability of people and their chance of staying employed. An action plan for adult education was also adopted, which anticipates an introduction of new measures and the increase in funding. Measures implemented by the EU employment policy will also be supported by structural policy funds. Lifelong learning measures are also supported by Phare 2003 program within the framework of the program of social and economic cohesion. A public tender for this program, valued EUR 3 million, was issued in October 2004.

5.5. Financial System

The reform of the financial sector in the area of regulation and harmonisation of the legal system with EU directives is continuing.[28] The laws already approved in 2004 and those envisaged for 2005 entail further transposing of EU directives in the banking and insurance sectors as well as the capital market. In the capital market the legal changes aimed at increasing the transparency of operations effected by issuers of securities traded on the organised market[29], as well as transposing provisions of the directive on financial instruments markets (ISD2) [30], which will abolish the concentration rule and introduce multilateral trading facilities, thus increasing competition in the organised securities markets. The upcoming prospectus directive will entail the mutual recognition of the prospectuses of securities' issuers from different member-states, thus abolishing national restrictions on companies' access to other capital markets for financing purposes.

Given the basic indicators that measure the level of development in the financial system, Slovenia continued to show progress during 2004. In 2003 the banks' total assets (including savings banks and savings and loan undertakings) were equivalent to 89.5% of GDP, while insurance premiums were equivalent to 5.0% of GDP (compared with 4.8% in 2002) while market capitalisation was 23.4% of GDP (23.2% in 2002).

Banks remain the most important financial intermediaries in the Slovenian market, and in the previous years they have made an intensive effort to develop a range of new services in addition to their traditional banking services. The very much needed internal restructuring and consolidation process is still underway in the banking sector and will be speeded up.

In particular during the last two years there have been structural changes in the pattern of consumer savings, with a sharp rise in the number of mutual funds and the value of assets held by them. An important development concerning the securities market was the conversion of the privatisation funds into ordinary public limited

[28] Laws and amendments adopted in 2004 entailed complete harmonisation with the acquis communautaire in the field of (i) cross-border credit transfers, (ii) settlement finality in payment and securities settlement systems and (iii) collective investment undertakings. Further harmonisation was achieved by the laws and amendments adopted in the field of insurance sector and powers and responsibilities of the Securities Market Agency.

[29] Amendments to the Securities Market Act, envisaged for the last quarter of 2004

[30] New Securities Market Act; preparations are envisaged for 2005.

companies in 2003. Nevertheless, the small size of the market and the resulting limited degree of competition is hindering faster development. Having joined the EU, Slovenia has now been included in the process of creating an integrated financial market in the EU, in line with the guidelines of the Lisbon Strategy and the Financial Services Action Plan.

6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

In the coming decades, the proportion of the population of Slovenia over 65 years of age will rise sharply compared to the working-age population. Faster ageing of the population will place strong pressure on public finances. To meet this challenge Slovenia must continue with the reform of the pension and health systems, reduce the debt-to-GDP ratio by achieving as soon as feasible a budget position in structural terms close-to-balance, generate a surplus in the long-term and increase the employment rate.

The demographic profile of Slovenian population in comparison to those in other EU countries presents some acute features. Life expectancy is shorter than in the most developed countries, therefore it can be expected to increase significantly over time. At the same time, fertility levels are the lowest in Europe, persisting at a value of around 1.2 children per woman.

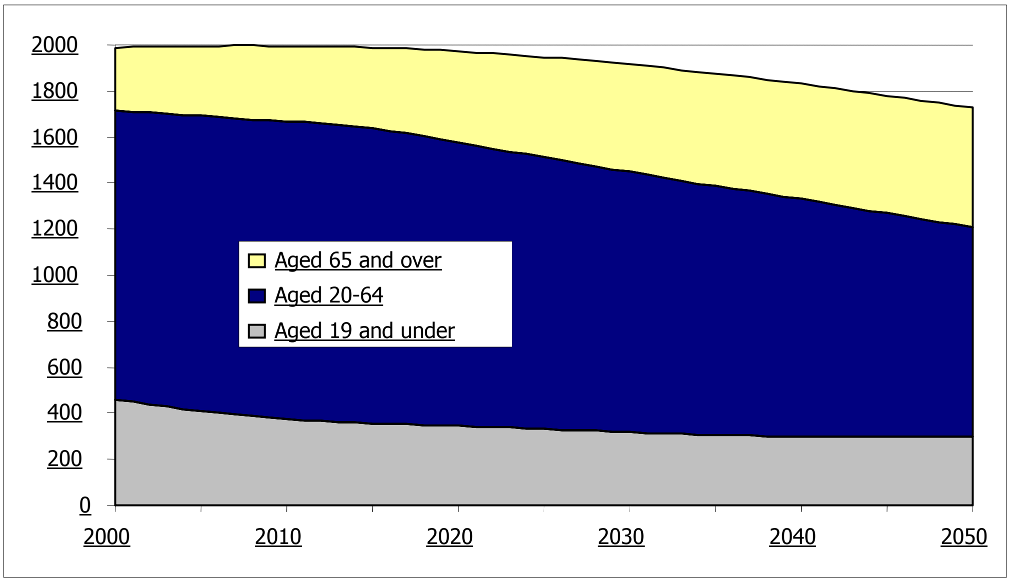
Currently, there are different sets of demographic projections for Slovenia in the years ahead with Eurostat's demographic projections for Slovenia not yet final. Preliminary population estimates by Eurostat seem to be more optimistic that the ones prepared in the spring 2004 by a working group of Slovenian demographic experts.[31] Similarly, in a recent assessment of the fiscal sustainability of the Slovenian pay-as-you-go pension system made by a World Bank consultant, the Slovenian demographic scenario lies somehow within the preliminary estimates of Eurostat and those made by a group of Slovenian experts.[32]Therefore, the fiscal impact of population ageing is still subject to a degree of uncertainty. Nevertheless, regardless the different demographic assessments, there is no doubt that whatever demographic scenario will actually materialized, the aging of Slovenian population represents a formidable challenge for fiscal policy.

According to Slovenias' experts the population of Slovenia will shrink by the middle of this century to around 1.72 million, representing a reduction of almost 270,000 people compared to 2003. The population structure will also change fundamentally, becoming in fiscal terms distinctly unfavorable. The population over 65 will increase from 295,000 (14.8%) in 2003 to 517,000 (29.9%) in 2050 (Figure 6.1). On the other hand, the population aged 20-64 will fall from approximately 63% in 2003 to less than 53% in 2050.

[31] Institute for Economic Research and UMAR.

[32] Patrick Wise., An Evaluation of the Fiscal Stability of Slovenia's Pay-As-You-Go Pension System. August 2004.

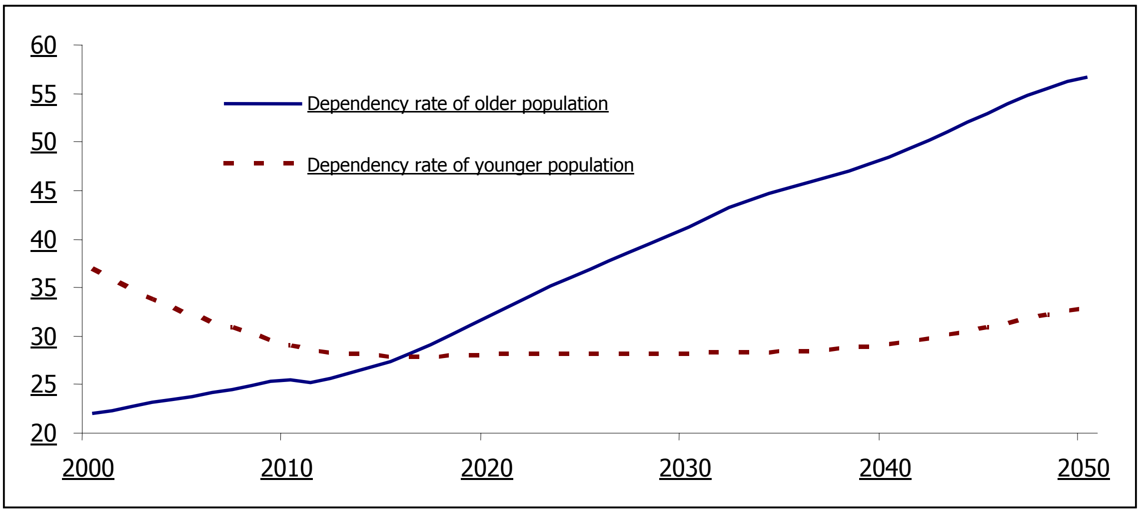
Figure 6.1: Demographic changes – population by individual age groups [000s]



Source: Statistical Office of the Republic of Slovenia and Institute for Economic Research.

The dependency rate[33] of the younger population, measured as the ratio between the number of persons aged under 20 per 100 persons aged 20-64 will in the next decade fall from the current level of 34 to 28, and will stabilise at this level (Figure 6.2).

Figure 6.2: Demographic rate of burden



Source: Statistical Office of the Republic of Slovenia and Institute for Economic Research.

As a response to the the impending demographic changes, Slovenia's pay-as-you-go pension system was reformed in 1999 and a White book on Health Reform system was prepared. The Pension reform package reduced the future hidden debt of the Pension Fund significantly by drastically cutting into the generosity of the system. In

[33] Normally the burden on the active population is expressed as the ratio between the number of people not of working age and the working-age population.

line with the World Bank analysis, the replacement rate for a full career would fall from 75% to less than 50% over a 50-year period, the average retirement age would rise by two years, and the internal rate of return promised by the system fall from 1.5% above wage growth to about 0.4% below wage growth.[34] A key element in the new system was the change in the pension indexation formula to approximately wage growth minus 0.5% enacted in 2001 which has already delivered important savings in the short-term while other parametric changes have a medium-term effect. The pension reform under implementation has already shown important results such as the lowering of the replacement rate from 75.8% in 1999 to 71.1% in 2003 and the increase in the average retirement age for men (one year and nine months) and women (10 months) since the reformed was enacted 1999. The share of pensions' expenditure in GDP is also gradually decreasing since 2002; in the period 2002-2007 the share will decrease by 0,8%.

There has been some progress on the health system reform, particularly with respect to expenditure contention measures (e.g. replacement of original by generic medicines and price reference for medicines) and improving efficiency such as reducing waiting lines. However, the health reform is still in its early stage and will continue to be implemented during the program period.

Besides continuing implementation of the pension and health reforms, the government will reduce debt from its current level of about 30% of GDP by achieving a close-to-balance position in the medium term. This process will be facilitated in the medium to long term by the reduction of certain categories of expenditures which are currently important, such as infrastructure building projects and certain programs of education whose relative importance will decline. The long-term sustainability of public finances will also depend strongly on the employment participation. Under optimistic assumptions the target value for the activity rate for the 15-64 age group is set at an ambitious 80% in 2050 and the unemployment rate is envisaged to fall from the current level of 6.7% to 2% in 2020 and stabilise at this level thereafter. In order to achieve this, the activity rates will have to be increased in all groups, particularly in groups with special difficulties in entering the labor market (young people and immigrants). Coping with the demographic challenge will also require net immigration to Slovenia.

Table 6.1 presents preliminary fiscal projections until the year 2050 based on the demographic scenario built by a group of Slovenian experts. Since there are not Slovenian official demographic projections until 2050 or final population projections from Eurostat the results should be considered as initial. After the projections presented in Table 6.1 were made in May 2004 an assessment of pension reform has been concluded in August 2004 based on an alternative demographic scenario which shows a different pension expenditure profile.[34] Given the fact that healthcare and pension expenditure in Table 6.1 were made on same demographic scenario the pension projections made in August are not included in Table 6.1.[35]

[34] Wise Patrick; An Evaluation of the Fiscal Stability of Slovenia's Pay-As-You-Go Pension System. August 2004.

[35] According to the August projections, the share of expenditure on pensions in GDP are as follows: 2005 13.3%; 2010 13.2%; 2020 14.0%; 2030 14.9%; 2040 15.1%; 2050 15.3%.

Table 6.1: Long-term sustainability of public finances

% of GDP	2005	2010	2020	2030	2040	2050
Total expenditure	48.3	47.5	46.7	48.0	51.2	55.7
Pensions	13.3	12.4	13.2	14.9	16.9	18.2
Healthcare	6.7	6.9	7.2	7.9	8.9	9.6
Interest payments	1.6	1.2	0.4	0.0	0.8	3.6
Total revenues	46.2	46.6	46.6	46.2	45.9	45.0
Of which: from pension (and disability) contributions	9.6	9.7	9.8	9.9	10.0	10.2
Assumptions						
Labor productivity growth	3.4	3.4	2.9	2.4	2.1	1.9
Real GDP growth	3.7	3.9	2.6	1.7	1.0	0.9
Activity rate males (aged 15-64)	71.3	73.8	76.8	78.8	80.9	84.6
Activity rate females (aged 15-64)	63.4	66.0	69.0	73.0	75.0	75.0
Total participation rates (aged 15-64)	67.4	70.0	73.0	76.0	78.0	80.0
Survey unemployment rate	6.3	3.6	2.0	2.0	2.0	2.0

Source: Institute for Economic Research, MFRS.

In line with the estimated effects of pension reform and the optimistic assumptions regarding the activity and unemployment rates, the fiscal situation in the next two decades based on May and August projections appears favorable. However, the fiscal position will deteriorate in the third decade of this century. Expenditures on health and particularly pensions will increase.