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ECFIN/2008/

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.02.2008
SEC (2008) 181 final

Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Slovenia, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first stability programme of Slovenia was submitted in December 2006. In accordance with the Regulation, the Council delivered an opinion on it on 27 February 2007 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Slovenia, submitted on 30 November 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

(1) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous stability programme)

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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

In its opinion of 27 February 2007, the Council summarised its assessment of the previous stability programme, covering the period 2006-2009, as follows. "The Council considers that, while the programme recognises that containing inflationary pressures and continued fiscal

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

consolidation are necessary to preserve the resilience of the economy, it envisages insufficient progress towards the MTO in spite of the upbeat growth prospects."

In view of its assessment, the Council invited Slovenia to

"(i) taking advantage of the good economic conditions, including the better than expected budgetary outcome in 2006, speed up the achievement of the MTO;

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

2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. In the area of budgetary policies, Slovenia was recommended to “take further steps to strengthen the reform of the pension system and promote active ageing, with a view to increasing the employment rate of older workers and improving long-term sustainability” In addition, all euro area Member States were recommended to “make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark” and “to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability”.

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007

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2 The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

3 OJ L 92, 3.4.2007, p. 23.

implementation report of Slovenia's national reform programme. This can be summarised as follows.

Slovenia's national reform programme identifies as key challenges/priorities a competitive economy and faster economic growth; a knowledge-based society; an efficient state; a modern social state and higher employment; and sustainable development.

The Commission's assessment was that Slovenia has made good progress in implementing its national reform programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Slovenia is recommended to give highest priority to the challenges in the areas of: pension reform and active ageing, with a view to long-term sustainability; flexible contractual arrangements to counter labour market segmentation and effectiveness of employment services, within a flexicurity approach.

In addition, Slovenia should also focus on the areas of: research and innovation strategy; competition in the services sector; implementation of energy efficiency measures; and implementation of plans to strengthen the link between the education system and the labour market.

Box: Main points covered by the assessment

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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

5 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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

On the updated stability programme of Slovenia, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the updated stability programme of Slovenia, which covers the period 2007 to 2010.

(2) Slovenia's generally strong GDP growth throughout the last decade peaked during the first year of membership in the euro area. However, a marked pick-up in inflation, mainly due to commodity price developments in conjunction with a lack of competition in some sectors, was also registered in 2007, with spill-overs to wages being a risk for 2008. Against the background of the strong economic growth during the run-up to EU and euro area entry, good progress in consolidating public finances was made. For the future, further fiscal consolidation will be needed to foster macroeconomic stability, including lower inflation. Addressing the recent acceleration of inflation in Slovenia would help preserve the competitiveness of this export-oriented economy. Moreover, the long-term sustainability of public finances remains a challenge in view of the significant expected effects of ageing on the budget in the absence of further pension reform. To support the economy's ongoing catching-up process, it will be important to continue with structural reforms, especially regarding labour and product markets. In the same context, further redirecting public expenditure towards growth-enhancing categories, while tackling budget rigidity and improving the efficiency of spending, will also be beneficial.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will slow from 5.8% in 2007 to 4.6% in 2008 and 4.1% in 2009 before picking up to reach 4.5% by the end of the programme period. Assessed against currently

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

available information[7], this scenario appears to be based on plausible growth assumptions, although risks for 2008 stemming from the external environment have increased since the completion of the stability programme. After the unexpected increase in inflation in 2007, the programme's projections for inflation are significantly higher than in last year's scenario. Nevertheless, they still appear to be on the low side for 2008 given recent developments in food and energy prices. Second-round effects from the strong pick-up in inflation in 2007 and further increases in administrative prices as well as possible demonstration effects from the steep public sector wage increases may lead to a more persistent inflation differential with the rest of the euro area and would entail less favourable competitiveness developments than implied by the programme.

(4) For 2007, the general government deficit is estimated at 0.7% of GDP in the Commission services' autumn 2007 forecast, against a target of 1.5% of GDP set in the 2006 programme. The difference is mainly explained by a positive base effect from the 2006 outcome and by higher-than-projected nominal GDP growth in 2007. At the same time, more positive-than-planned revenue developments are expected to have been offset, also in the 2007 update of the programme, by expenditure overruns. However, more recent information on a cash basis points to a better 2007 outturn, possibly a slight surplus. Overall, budgetary implementation in 2007 was in line with the Council opinion of 27 February on the 2006 stability programme, which had invited Slovenia to speed up the achievement of the MTO taking advantage of the good economic conditions, including the better-than-expected budgetary outcome in 2006[8], and also with the April 2007 Eurogroup orientations for budgetary policies.

(5) The main goal of the medium-term budgetary strategy in the update is to respect the medium-term objective (MTO), which is a structural deficit (i.e. a cyclically-adjusted deficit net of one-off and other temporary measures) of 1% of GDP, by a growing margin over the programme period, although some weakening is planned for 2008. This change vis-à-vis the previous programme's goal to reach the MTO by 2009 follows from the above mentioned better-than-expected 2006 outturn (mainly reflecting higher nominal GDP growth), which implied that the MTO had already been broadly met in 2006. Compared to the 2006 programme, the headline deficit planned in the 2007 update is about ½ percentage point of GDP lower throughout the programme period, against the background of a better starting position. The deficit is planned to widen to 0.9% of GDP in 2008 and then to gradually close, with the largest adjustment planned in the final year. Following a similar path, the primary surplus is projected to reach just above 1% of GDP by 2010. The planned consolidation results from expenditure restraint more than offsetting, except in 2008, the gradual decline in the revenue ratio. The projected decline of primary expenditure over the programme period amounts to 2¼ percentage points of GDP. While relatively broad-based, it reflects especially more contained developments of social spending. Largely influenced by the ongoing tax reform, the gradual decline in the revenue ratio, by 1¾ percentage points, is mainly driven by indirect taxes, while a slight increase in the direct tax burden is projected.

(6) The risks to the budgetary projections in the programme appear broadly balanced in 2008, whereas budgetary outcomes could be somewhat worse than targeted in the

7 The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

8 OJ C 70, 27.3.2007, p. 17.

outer years. In 2008, the possibility of a positive base effect due to a potentially better-than-expected 2007 budgetary outturn counterbalances the risks associated with the current deterioration of the external environment. Thereafter, there are certain risks to the implementation of the budgetary strategy due, in particular, to the sizeable magnitude of the back-loaded planned reduction in expenditure, with not all underlying measures spelt out in sufficient detail. To some degree, these risks are mitigated by Slovenia's good track record in the recent past, which suggests that outcomes might be better than expected.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO throughout the programme period, but with a possibly smaller margin than planned for the outer years. The slight deterioration of the structural balance envisaged for 2008 may turn out to be pro-cyclical, which would not be in line with the Stability and Growth Pact. Furthermore, a tighter fiscal stance than presently envisaged for 2008 appears to be warranted given the current strong inflationary pressures. This would also be in line with the April 2007 Eurogroup orientations for budgetary policies, which called for carefully designing fiscal policy plans for 2008 to avoid feeding macroeconomic imbalances. After 2008, the fiscal policy stance implied by the programme is in line with the Pact.

(8) Slovenia appears to be at high risk with regard to the sustainability of public finances. The budgetary position in 2007 as estimated in the programme remained roughly unchanged compared with 2006 and is just sufficient to stabilise the debt ratio over the long term before the budgetary impact of an ageing population is considered. However, the latter is well above the EU average, mainly reflecting a stronger increase in pension expenditure. High primary surpluses over the medium term and, in particular, further measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances.

(9) The stability programme seems to be consistent with the October 2007 implementation report of the national reform programme. In particular, both documents give account of the main reform measures under implementation, such as the comprehensive tax reform, infrastructure investments as well as changes to the system of social transfers. The programme does not include a detailed qualitative assessment of the overall impact of the national reform programme within the medium term fiscal strategy. However, while this is not done in a systematic way, information on the direct budgetary impact associated with major reforms envisaged is given and has been taken into account in budgetary projections.

(10) The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy. In particular, it does not include significant further measures to strengthen the reform of the pension system with a view to ensuring long-term sustainability.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data.[9]

The overall conclusion is that Slovenia met its MTO in 2007, two years ahead of previous plans, and that the programme aims at respecting the MTO by a growing margin over the programme period. For 2007, the most recent available information points to a better-than-planned budgetary outturn, possibly a slight surplus. However, for 2008, a slight deterioration of the structural balance is envisaged despite the continuing strong growth prospects. The risks to the budgetary projections are broadly balanced in 2008. In the outer years, budgetary outcomes might be slightly worse than targeted, mainly due to risks associated with the envisaged reliance on expenditure restraint. The expansionary stance in 2008 may turn out to be pro-cyclical. A tighter fiscal stance than presently envisaged for 2008 appears to be warranted also given the current strong inflationary pressures. The high projected increase in public sector wage settlements is also a concern for the inflation outlook. In spite of the current low debt level, Slovenia is assessed to be at high risk with regard to the long-term sustainability of public finances due to the significant projected budgetary impact of ageing.

In view of the above assessment and also in the light of the April 2007 Eurogroup orientations for fiscal policies, Slovenia is invited to:

(i) building on a likely better-than-expected outturn in 2007, aim for stronger budgetary positions in 2008 and beyond than planned in the programme, thereby avoiding pro-cyclical policies;

(ii) stand ready to adopt further measures to tame inflationary pressures, complementing the recommended fiscal stance with appropriate wage, labour market and competition policies;

(iii) in view of the projected increase in age related expenditure, improve the long-term sustainability of public finances, in particular by further reforming the pension system.

[9] In particular, the data on some external assumptions ("World excluding EU, GDP growth", "World import volumes, excluding EU" and on some items regarding sectoral balances as well as the breakdown of the stock-flow adjustment of the debt level are missing.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**SP Nov 2007**	**5.7**	**5.8**	**4.6**	**4.1**	**4.5**
	COM Nov 2007	5.7	6.0	4.6	4.0	n.a.
	SP Dec 2006	*4.7*	*4.3*	*4.2*	*4.1*	*n.a.*
HICP inflation (%)	**SP Nov 2007**	**2.5**	**3.4**	**3.5**	**2.8**	**2.6**
	COM Nov 2007	2.5	3.5	3.7	2.9	n.a.
	SP Dec 2006	*2.7*	*2.7*	*2.5*	*2.2*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-0.2**	**0.7**	**0.5**	**0.1**	**0.2**
	COM Nov 2007[2]	-0.2	0.9	0.8	0.3	n.a.
	SP Dec 2006	*-0.5*	*-0.2*	*0.0*	*0.3*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**-2.8**	**-3.5**	**-3.1**	**-2.0**	**-1.6**
	COM Nov 2007	-2.6	-3.3	-2.6	-1.9	n.a.
	SP Dec 2006	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Nov 2007**	**-1.2**	**-0.6**	**-0.9**	**-0.6**	**0.0**
	COM Nov 2007	-1.2	-0.7	-1.0	-0.8	n.a.
	SP Dec 2006	*-1.6*	*-1.5*	*-1.6*	*-1.0*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2007**	**0.2**	**0.7**	**0.2**	**0.6**	**1.1**
	COM Nov 2007	0.2	0.7	0.3	0.4	n.a.
	SP Dec 2006	*0.1*	*-0.1*	*-0.3*	*0.3*	*n.a.*
Cyclically-adjusted balance[2] (% of GDP)	**SP Nov 2007**	**-1.1**	**-0.9**	**-1.1**	**-0.7**	**-0.1**
	COM Nov 2007	-1.1	-1.1	-1.4	-1.0	n.a.
	SP Dec 2006	*-1.4*	*-1.4*	*-1.6*	*-1.1*	*n.a.*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**-1.1**	**-0.8**	**-1.0**	**-0.7**	**-0.1**
	COM Nov 2007	-1.1	-1.1	-1.4	-1.0	n.a.
	SP Dec 2006	*-1.4*	*-1.4*	*-1.6*	*-1.1*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2007**	**27.1**	**25.6**	**24.7**	**23.8**	**22.5**
	COM Nov 2007	27.1	25.6	24.5	23.8	n.a.
	SP Dec 2006	*28.5*	*28.2*	*28.3*	*27.7*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 4.2%, 4.9%, 4.7% and 4.5% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2007 and 0.1% in 2008, both deficit-increasing, according to the most recent programme. The Commission services do not consider these to be one-off measures hence there are no one-off measures in the Commission services' forecast.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations