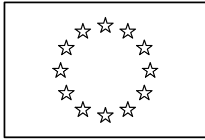

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.10.2009
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REPORT FROM THE COMMISSION

Slovenia

Report prepared in accordance with Article 104(3) of the Treaty

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn has brought about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Slovenia and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a

[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "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, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

According to data notified by the authorities in April 2009[2], the general government deficit in Slovenia is planned to reach 3.7% of GDP in 2009, thus exceeding the 3% of GDP reference value, while general government gross debt would be 28.8% of GDP, well below the 60% of GDP reference value but, at 6 percentage points of GDP higher than in 2008, discontinuing the downward trend observed since 2002. Since then, the authorities have revised upwards the above figures. In the subsequent April 2009 update of the stability programme, the 2009 general government deficit was set at 5.1% of GDP and the debt at 30.5% of GDP. In a letter of 21 August 2009, the authorities revised the planned deficit figure further up, to 5.5% of GDP.

Table 1: General government deficit and debt [a]

	2003	2004	2005	2006	2007	2008	2009		2010
							COM	MS	COM
General government balance	-2.7	-2.2	-1.4	-1.3	0.5	-0.9	-5.5	-3.7	-6.5
General government gross debt	27.5	27.2	27.0	26.7	23.4	22.8	29.3	28.8	34.9

Note:
[a] In percent of GDP.
Source: Eurostat, Commission services' spring 2009 forecasts (COM) and spring 2009 EDP notification (MS).

The planned figure for the 2009 deficit provides *prima facie* evidence on the existence of an excessive deficit in Slovenia in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Slovenia with the adoption of this report. Section 3 of the report examines the deficit criterion, and Section 4 the debt criterion. Section 5 deals with public investment and other relevant factors. The report takes into account the Commission services' spring 2009 forecasts, released on 4 May, and their evaluation of subsequent developments.

3. DEFICIT CRITERION

The planned deficit for 2009 in the April 2009 EDP notification is 3.7% of GDP. Based on the information provided by the Slovenian authorities, the government is now planning to reach a deficit of 5.5% of GDP in 2009.

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2 According to Council Regulation (EC) No 479/2009 (previously Council Regulation (EC) 3605/93), Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Slovenia can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

Well in excess of 3% of GDP, the planned deficit is not close to the Treaty reference value.

The planned excess over the 3% of GDP reference value is exceptional. In particular, it results, among other things, from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. Real GDP growth, which halved between 2007 and 2008, is projected to be sharply negative in 2009 (-3.4%) according to the Commission services' spring 2009 forecast. While estimates of the output gap should be interpreted with caution, a negative output gap is projected to open up in 2009. On 31 August, the statistical office of Slovenia published preliminary national accounts data for the first two quarters of 2009, showing real GDP growth of –6.4% quarter-on-quarter in Q1 (seasonally- and working-day adjusted) and +0.7% in Q2. This suggests that the decline in real GDP in 2009 could be worse than foreseen in the Commission services' spring 2009 forecast. However, it must also be noted that, although Slovenia's budgetary outcomes have been good in the recent past when economic conditions were still favourable, thanks to higher-than-budgeted revenue growth, budgetary execution was marked by expenditure overruns.

Table 2: Macroeconomic and budgetary developments [a]

	2003	2004	2005	2006	2007	2008	2009		2010	
							COM	SP	COM	SP
Real GDP (% change)	2.8	4.3	4.3	5.9	6.8	3.5	-3.4	-4.0	0.7	1.0
Potential GDP (% change)[c]	3.9	3.8	3.6	3.7	3.9	4.9	1.0	2.6	2.2	2.3
Output gap (% of potential GDP)[c]	-1.5	-1.1	-0.4	1.7	4.5	3.2	-1.3	-2.3	-2.7	-3.5
General government balance	-2.7	-2.2	-1.4	-1.3	0.5	-0.9	-5.5	-5.1	-6.5	-3.9
Primary balance	-0.7	-0.5	0.1	0.1	1.8	0.2	-3.9	-3.6	-4.7	-2.2
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government gross fixed capital formation	3.2	3.5	3.2	3.7	3.7	4.2	4.4	4.2	4.4	4.1
Cyclically-adjusted balance[c]	-1.9	-1.7	-1.3	-2.1	-1.7	-2.5	-4.9	-4.1	-5.2	-2.3
Cyclically-adjusted primary balance	0.0	0.0	0.3	-0.7	-0.4	-1.3	-3.3	-2.6	-3.4	-0.6
Structural balance [b, c]	-1.9	-1.7	-1.3	-2.1	-1.7	-2.5	-4.9	-4.1	-5.2	-2.3
Structural primary balance	0.0	0.0	0.3	-0.7	-0.4	-1.3	-3.3	-2.6	-3.4	-0.6

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Cyclically-adjusted balance excluding one-off and other temporary measures.

[c] For the stability programme, potential GDP, the output gap and the cyclically-adjusted and structural balances are recalculated by the Commission services on the basis of the information in the programme.

Source: Eurostat, Commission services' spring 2009 forecasts (COM) and April 2009 update of the stability programme (SP).

The planned excess over the 3% of GDP reference value is not temporary in the sense of the Treaty and the Stability and Growth Pact. The Commission services' spring 2009 forecast projects that, from 5.5% of GDP in 2009, the deficit would widen in 2010, to 6.5% of GDP on the no-policy change assumption, while real GDP is forecast to recover to mildly positive growth. This assumption takes into account that, according to government plans, most measures of extraordinary nature linked to the crisis will be rolled back in 2010.

According to the April 2009 stability programme, the deficit is projected to remain above the reference value until the end of the programme period (2011), when it is targeted to be 3.4% of GDP.

In sum, the planned deficit is not close to the 3% of GDP reference value. The planned excess over the reference value is exceptional but not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

4. DEBT CRITERION

General government gross debt was around 27% of GDP over the period 2003-2006 and declined by around 4 percentage points between 2006 and 2008, to 22.8% of GDP. The planned debt for 2009 in the April 2009 EDP notification is 28.8% of GDP, 6 percentage points higher than in 2008. The sizeable increase in the primary deficit accounts for more than half of the rise in the debt ratio. The remainder of the increase is due to rising interest expenditure, the fall in nominal GDP and a debt-increasing stock-flow adjustment reflecting recapitalisations and liquidity operations to support the financial sector. According to the Commission services' spring 2009 forecast, the debt ratio would, on a no-policy change basis, rise further, to some 35% of GDP by 2010. The debt ratio remains well below the 60% of GDP reference value.

5. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; and (4) other factors considered relevant by the Commission.

5.1. Medium-term economic position

Cyclical conditions and potential growth. Slovenia has enjoyed solid economic growth in recent years, averaging 5% over the period 2004-2008 and marked by rapid growth in exports and investments. Due to its high degree of openness, the Slovenian economy has been severely hit by the global recession, but rising unit labour costs and inflation well above the euro area average also played a role. Activity decelerated markedly throughout 2008, with a steep fall in the final quarter, and shrunk again significantly in the first quarter of 2009. Assuming a (subdued) global recovery, well-functioning financial markets and preserved competitiveness, the Commission services' spring 2009 forecast expects a slow recovery in 2010. Having reached a low level of just above 4% in the second half of 2008, the unemployment rate started increasing in early 2009 and could rise to more than 7% by 2010. Potential growth is projected to slow down from around 5% in 2008 to 1% in 2009 (and 2.2% in 2010), reflecting fewer hours worked and lower capital accumulation as a consequence of the drop in investment. Based on the Commission services' spring 2009 forecast, the output gap peaked at 4½% of potential GDP in 2007 and is expected to turn sharply negative in 2009 and to widen in 2010. The external deficit, which had been on an increasing trend since 2005, is estimated to narrow from its 2008 peak (6% of GDP) to around 4½% of GDP in 2010.

Recent structural reforms. To pave the way for EU accession (2004) and euro entry (2007), Slovenia introduced important structural reforms in product and labour markets, the financial sector and the tax system. The implementation of the reform agenda is being taken forward,

albeit gradually. Positive steps have been taken in some key microeconomic areas, such as entrepreneurship, better regulation and the liberalisation of network industries. However, to strengthen resilience and increase competitiveness in the longer run, a more effective research and innovation strategy and a better alignment of wage and productivity developments are needed, while there remains scope for enhancing competition in services. In the labour market area, eligibility for social benefits has been tightened and activation policies helping people into employment, which have been enhanced, should continue in the light of the economic downturn. A major tax reform has reduced the fiscal burden on labour and capital. Excessive employment protection has been reduced, but so far mainly on temporary contracts. Better integrating young people into the labour market and raising the low employment rate of older people remain important structural labour market challenges.

5.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. The general government balance improved until 2007, when a small surplus was recorded. However, also in view of gradual changes to the tax system, the annual improvement over the period 2004-2008, when Slovenia experienced economic good times, averaged only ¼ percentage point of GDP. In structural terms, the government position did not improve between 2004 and 2007 and worsened in 2008. The good economic times were thus not exploited to make progress with fiscal consolidation. A tighter fiscal stance would have been warranted also in view of the strong inflationary pressures witnessed in 2008.

According to the Commission services' spring 2009 forecast, the economy is expected to enter economic bad times in 2009. The headline deficit is forecast to widen by 4½ percentage points of GDP in 2009 and the structural position by 2½ percentage points of GDP, pointing to an expansionary fiscal stance. Notwithstanding uncertainties surrounding estimates of the output gap, the budgetary position is projected to move further away from the medium-term objective for the budgetary position (a structural deficit of 1% of GDP in the case of Slovenia) according to the Commission services' spring 2009 forecast.

Public investment. Government investment as a share of GDP increased by 1 percentage point between 2005 and 2008, to just above 4% of GDP, while the deficit narrowed by 0.5 percentage points over the same period. Although the Commission services' spring 2009 forecast expects a further small rise in the government investment ratio in 2009, the steep increase in the government deficit implies that in 2009-2010 the deficit ratio would exceed the public investment ratio for the first time since 2001. A broadly similar picture results when comparing the public investment ratio with the structural deficit ratio.

Quality of public finances. While government expenditure as a percent of GDP had been on a declining trend since 2003, it rose strongly in 2008, to 43.6%, still the fourth-lowest in the euro area. The increase in government expenditure in 2008 was more than 10%. About half of this increase was due to government consumption, one-third to social transfers and the rest to public investment. As mentioned above, the government wage bill and social transfers experience strong dynamics also in 2009 and the Commission services' spring 2009 forecast projects government expenditure to increase by another 7½% in 2009. Although the stability programme announces savings in these two expenditure categories as well as downward adjustments to public investment plans, the announced savings, which should have impacted already on the 2009 deficit outcome, have not all been confirmed in the supplementary budget. For 2010-2011, the stability programme plans a withdrawal of the fiscal stimulus in line with economic recovery and gradual narrowing of the deficit, with the envisaged

consolidation falling predominantly on the expenditure side, especially through a decline in subsidies as a percent of GDP and the containment of government consumption (the wage bill and intermediate consumption) and social transfers, which will require a strong commitment. The Slovenian budgetary framework offers scope for improvement, especially in the area of spending control, given higher-than-budgeted expenditure growth in the period 2006-2008 and the reliance of the medium-term consolidation strategy laid down in the stability programme on expenditure restraint. At the same time, public spending efficiency and effectiveness, including in the area of health care, could be enhanced so as to help ensure that expenditure restraint does not compromise the level of services provided. To achieve this goal, the government intends to introduce performance-based budgeting as of the next budgetary cycle (2010-2011).

Long-term sustainability of public finances. In its opinion of 7 July 2009 on the April 2009 update of the stability programme, the Council assessed the long-term sustainability of Slovenia's public finances. In particular, the Council was of the opinion that the long-term budgetary impact of ageing in Slovenia is well above the EU average, mainly as a result of a relatively high projected increase in pension expenditure as a share of GDP over the coming decades. The budgetary position in 2008 estimated in the programme, which is worse than the starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. Reducing the primary deficit over the medium term, as foreseen in the programme, and a further pension reform aimed at curbing the substantial increase in age-related expenditures, in particular by encouraging longer working lives, would contribute to reducing the high risks to the long-term sustainability of public finances[3]. The risks from financial sector stabilisation schemes (e.g. guarantees) put in place by Slovenia could have a potential negative impact on the long-term sustainability of public finances unless some of the cost of the government support can be recouped in the future.

5.3. Other factors put forward by the Member State

In a letter of 21 August 2009, the Slovenian authorities listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above already covers most of the items put forward by the authorities. The letter emphasises that the widening of the deficit in 2009 reflects the operation of automatic stabilisers and discretionary measures in line with the EERP and that the severity of the downturn will affect the budgetary position and fiscal policy also in the coming years, with nominal tax revenue expected to reach its 2008 level only in 2011. Combined with the envisaged degree of expenditure restructuring and restraint over the next four years (by 3.3% of GDP) and the commitment to a public investment ratio of 4% of GDP in view of catching-up needs, this would restore the deficit below the 3% of GDP reference value by 2012.

5.4. Other factors considered relevant by the Commission

The widening deficit in 2009 is the result of the working of automatic stabilisers, the strong dynamics of social transfers (especially from indexation arrangements) and compensation of employees (owing to the agreement to address "wage disparities") and various discretionary measures. The latter include recovery measures in line with the EERP (which add up to

[3] Since the submission of the stability programme, risks to the long-term sustainability may have changed in view of the worsened economic and budgetary situation. The new assessment will be published in the upcoming report on the long-term sustainability of public finances in the European Union.

almost 1¼% of GDP), as well as tax relief benefiting companies decided before the onset of the crisis (around ¾% of GDP). In its opinion of 7 July 2009 on the April 2009 update of the stability programme, the Council concluded that fiscal policy in Slovenia would be expansionary in 2009 in line with the EERP. The measures appeared to be an adequate response to the economic downturn given the room for fiscal manoeuvre offered by the moderate deficit and debt levels going into the crisis. They were considered to be timely, targeted and partly temporary. At the same time, as the room for fiscal manoeuvre was constrained by the long-term sustainability challenge, consolidation measures to help finance the stimulus measures had been adopted. The programme, (which was submitted after the finalisation of the Commission Services' spring 2009 forecast) announced additional savings for 2009 that appeared to have been only partly confirmed in the June supplementary budget. Thereafter the programme planned a return to fiscal consolidation but the deficit was not foreseen to be brought below the reference value by the end of the programme period (2011). The Council emphasised that the budgetary strategy was subject to downside risks, as economic growth could be lower than projected. In addition, it could be difficult to reverse the stimulus measures and expenditure overruns could not be excluded. Although the debt ratio was low, the Council assessed Slovenia to be at high risk with regard to the long-term sustainability of public finances due to the significant projected budgetary impact of ageing. The Council invited Slovenia to: (i) implement the stimulus measures in 2009 in line with the EERP and the SGP; (ii) start reversing the fiscal stimulus as planned in the programme in 2010 and implement a significant consolidation thereafter via concrete measures; in so doing, keep tight control over government expenditure, including through implementing the planned improvements in the budgetary framework; (iii) in view of the projected increase in age-related expenditure, improve the long-term sustainability of public finances by further reforming the pension system, in particular with a view to encouraging longer working lives.

Slovenia adopted several measures to strengthen the stability of the financial sector. In autumn 2008 an unlimited government guarantee on bank deposits of individuals was introduced. In addition, the government is entitled to utilise the following types of measures: (i) loans to, and equity investments in, credit institutions, (re-)insurance companies and pension companies; (ii) government guarantees to credit institutions for refinancing operations; and (iii) purchases of claims from credit institutions. These measures are planned to be phased out by the end of 2010. A second set of measures, adopted in early 2009, consists of a government guarantee scheme for bank loans to enterprises and the recapitalisation of the Slovene Export and Development Bank and of the Fund for Entrepreneurship (together amounting to 0.6% of GDP). Furthermore, a guarantee scheme for natural persons taking out housing loans, amounting to 1.0% of GDP, was adopted in July. The ceiling on the overall volume of government guarantees provided in the context of the measures to strengthen the stability of the financial sector has been set at EUR 12 billion (33% of GDP). Finally, the government has temporarily deposited the proceeds of some recent bond issuances (EUR 1.6 billion or 4.4% of GDP) with banks.

6. CONCLUSIONS

The planned deficit for 2009 in the April 2009 EDP notification is 3.7% of GDP. Based on the information provided by the Slovenian authorities on 21 August 2009, the government is now planning to reach a deficit of 5.5% of GDP in 2009. The planned deficit is above and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact

but it cannot be considered as temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60% of GDP reference value.

In line with the Treaty, this report has also examined "relevant factors", which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The existence of a severe economic downturn, with public finance implications, increases the need to undertake enhanced surveillance under the EDP.