Summary

In 2007, the fiscal consolidation in most EU Member States was the fastest in recent years against the background of good cyclical conditions. The general government deficit has reached its lowest level in the entire EU area (0.9% of GDP) and the euro area (0.6% of GDP). The most significant contribution to this reduction was made by countries indicating deficits above the reference value of 3% of GDP. Due to a primary surplus increase and favourable nominal GDP growth rate, government debt has also declined the most so far. In the euro area, it has fallen below the reference value (58.7% of GDP), while in the EU it is slightly higher (66.2% of GDP). The reduction in government deficits and government debt was in general greater than envisaged in strategic budget documents, largely because of favourable macroeconomic conditions.

In Slovenia the lowest shares of general government deficit and general government debt in GDP were reached after 2000. Last year, the general government position was close to being in balance (-0.1% of GDP). Total nominal revenues increased significantly more in comparison to total expenditure, and growth in both categories was lower than GDP growth. General government revenue as a share of GDP declined by 0.9 percentage points to 43.2%. As expected, revenue growth was slightly slowed by the introduction of tax reform, but due to favourable macroeconomic developments, tax revenues have been higher than planned. The reduction in the share of general government expenditure has also been the highest thus far. After a reduction in the past four years by approximately 0.5 p.p. in relation to the preceding year, general government expenditure decreased by 2 p.p. to 43.3% of GDP last year. The share of social transfers declined most, due to the introduction of a uniform inflation indexation mechanism, and because of the decelerated growth rate in the number of employees and slow growth of wages per employee in the public sector, the share of compensation of employees was also significantly lower. The accelerated reduction in the government deficit has contributed to a reduction in general government debt. Due to the replacement of expensive forms of borrowing with cheaper alternatives and early debt repayment, and due to further effective interest rate reduction, the consolidated general government debt in GDP has reached the lowest level to date, 24.1% of GDP. The relative share of guarantees has been increasing, while the shares of guarantees called have become relatively smaller.

The cyclically adjusted deficit decreased by 0.5 p.p. last year and exceeded the actual deficit by 0.4 p.p. Despite the significant improvement in the nominal fiscal position, most EU Member States have not fulfilled their plans regarding structural deficit reduction. In Slovenia, deficit reduction was faster than envisaged in the amendment to the Stability Programme dating from the end of last year, according to which Slovenia should reach a balanced fiscal position by 2010. Also in compliance with the provisions of the medium-term budget objectives within the Stability and Growth Pact was the improvement in the cyclically adjusted deficit, which last year declined by 0.5 p.p. according to recent estimates but was still higher than the actual deficit.

In 2007, fiscal policy kept a counter-cyclical orientation and became restrictive. Considering changes in the output gap in the last year, cyclically adjusted deficit reduction means that fiscal policy was counter-cyclically oriented. An improvement in the cyclically adjusted deficit in the first year after integration in

the EMU meant an appropriate fiscal policy response from the point of view of its stabilising role.

The preservation of the long-term sustainability of public finance remains a key fiscal policy challenge. In the case of the same parameters of systems of social protection and economic policy, the general government debt in Slovenia would start to increase after 2015 due to the rapid increase in the number of older people indicated by demographic projections. Due to an expected rise in general government expenditure related to ageing, which will increase pressure on public finance in the next decades, the search for solutions for long-term fiscal sustainability is the key challenge of fiscal policy.

For sound public finance, progress in implementing structural changes, in addition to budget consolidation, is of key importance. Within the strategic framework of the implementation of EU economic policies, public finance quality is becoming an increasingly important factor for the provision of conditions for long-term economic growth and the sustainability of public finance. The quality of public finance is determined by a modern institutional framework, with a comprehensive legal basis and budget procedures, clearly defined goals and fiscal rules, as well as instruments for monitoring and measuring the efficiency of general government revenue and expenditure. The conceptual basis of public finance quality analysis is in preparation; at EU level, the first foundations were established with the multi-dimensional framework proposed by the European Commission.

Among the measures directed towards gradually strengthening the development role of fiscal policy in Slovenia, tax reform was adopted with the aim of increasing the competitiveness of the economy. The tax changes introduced have generally reduced tax burdens. Due to the amended income tax legislation and gradual abolition of the payroll tax, the burden of taxes and contributions on wages has been alleviated. The change in the tax scale has mostly favoured taxable persons in the lowest and highest income brackets. On the other hand, estimates of the results of tax reform on the corporate income tax – which reduced the general tax rate but made the regime of tax relief stricter – show that the effective tax rate increased and therefore the burden on the economy increased. The tax burden on the economy continued to decline because of the further abolition of the payroll tax.

Comprehensive measurements of the efficiency and effectiveness of general government expenditure is impeded by methodological deficiencies, but analyses of the efficiency of social expenditure and state aid show effects. The available indicators show that social expenditure achieved its goals: on average, Slovenia spends relatively little for social security compared to other EU Member States. Slovenia has lower administrative costs for social expenditure management, but at the same time also has a lower at-risk-of-poverty rate and income inequality. The analysis of state aid efficiency and its impact on the competitiveness of the economy revealed that aid intended for small or medium-size enterprises, research and development and employment incentives are efficient. Aid for other purposes is less efficient (training, regional goals) or inefficient (rescue and restructuring, special sectoral aid). Otherwise, efficient purposes could enable the achievement of the set objectives on a much larger scale if we did not pursue the goal of "saving" less successful companies, but allocated aid based on the criterion of

"additionality" to recipients who could achieve the highest possible effects. Since aid is highly concentrated, it compromises competition in the market and their fragmentation indicates that in the light of expenditure and costs they are above average.

Introduction

Since integration in the Economic and Monetary Union (EMU), fiscal policy and incomes policy have had a greater stabilising role. Already in the first year after introduction of the euro, when in favourable cyclical conditions pressures on the internal and external balance of the economy began, appropriate fiscal policy was one of the most important economic issues.

The strategic framework of economic policy implementation in the fiscal policy of the EU determines stabilisation tasks, as well as development roles. Sound and transparent public finance and good fiscal policy enabling the more efficient use of resources have proved to be the key conditions for sustainable economic growth. Due to requirements for the coverage of more pronounced liabilities related to unfavourable demographic trends, but in respect of an unchanged commitment to reduce the share of public spending and general government deficits, public finance quality improvement is becoming a broader economic issue. Institutional structure, procedures and rules focused on results and effects (and not on sources used) have become more important.

In this year's fiscal chapter, we therefore deal with two views of fiscal policy: stabilisation and developmental. The first part is intended as a review of fiscal development and policy in the last period. In the first section, public finance development in the EU is presented, and the second section deals in detail with the development of budget aggregates and flows in Slovenia, including an analysis of cyclical and structural factors and sustainability elements. The third section is new, and presents a methodological and analytical basis for the integral monitoring of public finance quality. Key findings and recommendations resulting from it are enumerated in the fourth section.

1. Fiscal development and policy in the European Union[1]

In 2007, the budget deficit in the euro area and the EU reached the lowest level since the early 1970s. The "record-low" level of the deficit in the euro area (0.6% of GDP) and the EU (0.9% of GDP) was achieved thanks to both favourable economic conditions and discretionary efforts. Many countries have used a part of the revenue windfalls to reduce taxes or increase expenditures.

The decline in the deficit in the euro area and the EU in 2007 reflects a relatively broad-based trend across countries with a significant contribution from countries with excessive deficits. While progress is not homogeneous across countries, the effort was particularly notable in countries that in the past had breached the 3% of GDP threshold of the Treaty.[2] The fiscal position of twelve

[1] This chapter is based on contributions from Martin Larch (advisor, BEPA) and Marko Mršnik (Standard & Poor's)

[2] In January 2006, twelve countries were still subject to the excessive deficit procedures (EDP) of the Stability and Growth Pact (SGP). Two years on, all euro area countries succeeded in bringing their deficits below the threshold and only Hungary remains in EDP. A new procedure was opened for the UK on 8 July.

Member States – two more than a year before – is in line with or exceeds their medium-term objective. With the exception of very few countries (Ireland, France and the United Kingdom) the 2007 deficit outcomes outperformed the targets presented in the 2006/07 updates of the Stability and Convergence Programmes (see Box 1). Particularly important progress was made in Germany, where the nominal deficit fell by 1.6% of GDP and a balanced budget was achieved.

Contrary to the adjustment strategy, actual budget implementation departed from planned expenditure reductions. Following a recurrent pattern observed in the past, the majority of Member States reported expenditure slippages (including additional discretionary spending), which could be mostly covered by higher-than-expected revenues. This outcome contrasts with the policy advice of the Council opinions on the 2006/07 updates of the Stability and Convergence Programmes and, for the euro area countries, with the commitments made in the spring of 2007 in Berlin, namely to fully use extra revenues to reduce deficits and debt.

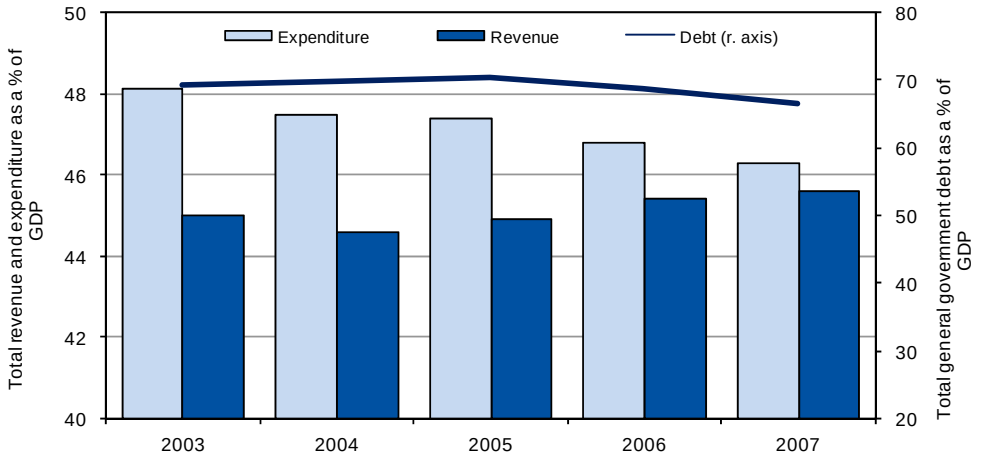
Table 1: Headline and structural general government balances in the EU

	Nominal balance (as a % of GDP)					Structural balance (as a % of GDP)				
	2003	**2004**	**2005**	**2006**	**2007**	**2003**	**2004**	**2005**	**2006**	**2007**
BE	0.0	0.0	-2.3	0.3	-0.2	-1.1	-0.9	-0.2	-0.6	-0.3
DE	-4.0	-3.8	-3.4	-1.6	0.0	-3.3	-3.0	-2.4	-1.4	-0.3
IE	0.4	1.4	1.6	3.0	0.3	-0.1	2.1	1.3	2.9	0.2
EL	-5.6	-7.4	-5.1	-2.6	-2.8	-5.9	-8.0	-5.7	-3.7	-3.3
ES	-0.2	-0.3	1.0	1.8	2.2	-0.3	-0.2	1.2	2.0	2.4
FR	-4.1	-3.6	-2.9	-2.4	-2.7	-4.0	-3.8	-3.6	-2.7	-2.7
IT	-3.5	-3.5	-4.2	-3.4	-1.9	-5.1	-4.7	-4.5	-2.8	-1.5
CY	-6.5	-4.1	-2.4	-1.2	3.3	-8.1	-4.9	-2.8	-0.7	3.5
LU	0.5	-1.2	-0.1	1.3	2.9	1.2	-0.9	0.4	1.4	2.8
MT	-9.8	-4.6	-3.0	-2.5	-1.8	-6.5	-4.2	-3.8	-2.9	-2.4
NL	-3.1	-1.7	-0.3	0.5	0.4	-2.0	-1.1	0.8	1.1	0.3
AT	-1.4	-3.7	-1.5	-1.5	-0.5	-0.6	-3.1	-0.8	-1.4	-1.0
PT	-2.9	-3.4	-6.1	-3.9	-2.6	-4.7	-4.9	-5.2	-3.2	-2.2
SI	-2.7	-2.3	-1.5	-1.2	-0.1	-1.9	-1.6	-0.9	-1.3	-0.7
FI	2.6	2.4	2.9	4.1	5.3	3.3	2.9	3.7	4.2	4.9
EMU-15	**-3.1**	**-2.9**	**-2.5**	**-1.3**	**-0.6**	**-3.1**	**-2.9**	**-2.2**	**-1.2**	**-0.7**
BG	0.0	1.4	1.8	3.0	3.4	0.0	1.0	1.5	2.5	3.1
CZ	-6.6	-3.0	-3.6	-2.7	-1.6	-5.5	-1.3	-3.3	-2.9	-2.3
DK	0.0	1.9	5.0	4.8	4.4	0.9	2.5	5.3	4.1	3.9
EE	1.8	1.6	1.8	3.4	2.8	2.0	1.6	1.2	1.0	1.3
LV	-1.6	-1.0	-0.4	-0.2	0.0	-1.2	-0.8	-0.5	-1.1	-1.4
LT	-1.3	-1.5	-0.5	-0.5	-1.2	-1.9	-2.1	-1.1	-1.0	-1.4
HU	-7.2	-6.5	-7.8	-9.2	-5.5	-6.8	-6.9	-8.6	-9.7	-4.7
PL	-6.3	-5.7	-4.3	-3.8	-2.0	-5.9	-5.9	-4.2	-4.0	-2.5
RO	-1.5	-1.2	-1.2	-2.2	-2.5	-0.8	-1.8	-1.6	-2.7	-3.4
SK	-2.7	-2.4	-2.8	-3.6	-2.2	-1.4	-1.4	-1.0	-3.1	-2.6
SE	-0.9	0.8	2.2	2.3	3.5	-0.2	0.2	1.9	1.5	2.8
UK	-3.3	-3.4	-3.4	-2.6	-2.9	-3.4	-3.7	-3.4	-2.8	-3.0
EU-27	**-3.1**	**-2.8**	**-2.5**	**-1.4**	**-0.9**	**-3.0**	**-2.9**	**-2.2**	**-1.5**	**-1.0**

Source: European Commission

In 2007, debt reduction continued and largely thanks to an increase in primary surpluses and was coupled with favourable nominal GDP growth. The debt ratio of the EU as a whole dropped below the 60% of GDP threshold of the Treaty in the euro area; the debt ratio also stayed on a downward trend yet remained six percentage points above the threshold. The reduction in government gross debt levels in percent of GDP was broad-based across countries. Among the ten Member States which in 2006 had recorded a debt ratio of more than 60% of GDP, there were only two – France and Hungary – whose government debt increased in 2007. With a debt ratio of 104% of GDP, Italy remains the country with the highest degree of indebtedness in the Union.

Figure 1: **Total general government revenue, expenditure and debt in the euro area**



Source: Eurostat

Box 1: **Factors in the improvement of fiscal positions in the EU**

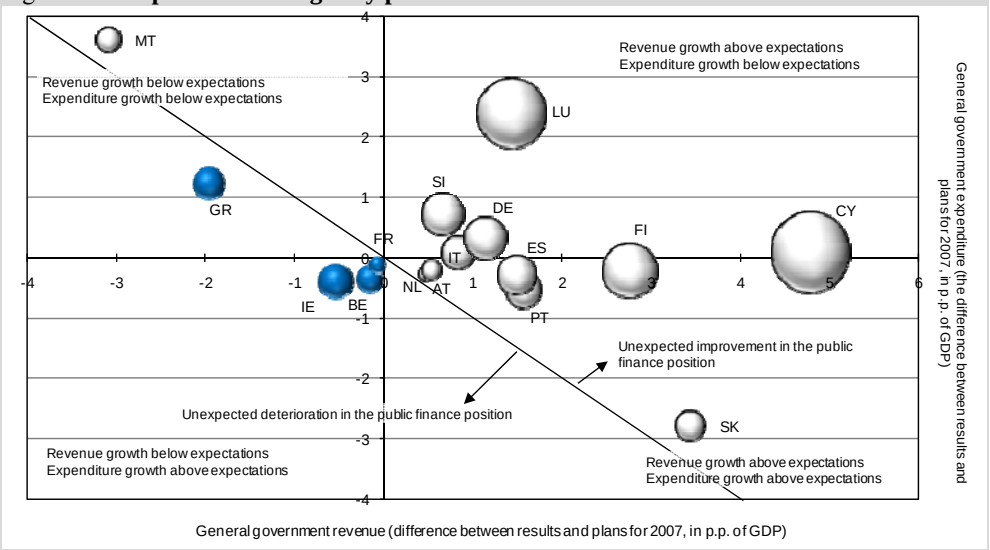
The improvement of the fiscal position in the EU and in the euro area is due to cyclical as well as structural factors. Estimating individual factors is difficult due to significant tax elasticity variation. The response of tax revenues to greater economic activity was well above average in several countries in the euro area, because in the past two years revenues have grown faster than nominal economic growth. This was also supported by trends in corporate profits, high oil prices and vigorous growth of domestic demand components (especially private consumption and investment). At the same time, they are a reflection of increased financial and non-financial asset values resulting from growth in the equity and housing markets.

A comparison of budgetary plans and results for 2007 shows that the euro area countries largely underestimated nominal economic growth due to lower than expected real economic growth and inflation. Comparison of actual results for 2007 with budgetary plans from the Stability and Convergence Programmes dating from the end of 2006 enables an insight into the dynamics of total general government revenues in the past year in relation to original expectations and also estimates the nature of expenditure policies (see Figure 2).[3] The majority of countries managed to achieve a better fiscal position considering their original expectations, but the results are quite diverse in relation to revenue and expenditure components.

[3] Standard & Poor's (2008): Budgetary Developments in Europe: Past Simple, Future Tense.

Last year, the inflow of funds on the revenue side in all countries, with the exception of Malta and Greece, was significantly higher than envisaged in the Stability and Convergence Programmes from the year 2006. Some of this positive discrepancy can be explained by the relatively careful forecasts of nominal economic growth and exceeding the tax elasticity assumed in the budgets. Strong economic growth was also reflected in the increase in employment and the reduction in unemployment, which had a positive impact on public finance. In countries where structural measures had been introduced on the revenue side (e.g. tax reform in Slovenia), these measures were successful due to the favourable economic conditions and did not lead to tax revenue reduction.

Figure 2: **Comparison of budgetary plans and results for 2007**



Source: Stability and Convergence Programmes 2006, Eurostat and authors' calculations
Note: The size of the circle represents the deviation of the actual general government balance from the expected balance (based on the Stability and Convergence Programmes).

The expenditure side is more foreseeable regarding budget plans, since the cyclical component represents a relatively smaller share than on the revenue side. In general, the monitoring of expenditures has been crucial in the past two years for the improvement of the fiscal position, since revenues were much higher than expected and budgetary objectives could very weel be achieved under loosened discipline on the expenditure side. In this way, in some countries general government expenditure increased in relation to plans, despite the favourable cycle.

Most countries improved their fiscal position through changes on the revenue side. Figure 2 shows that Cyprus (where revenue growth strongly exceeded planned growth, due to high profits in the financial sector and real estate investments) and Finland (where revenues received a boost from returns on the national pension fund) lead among those countries where an improvement in the fiscal position was above expectations. Both countries achieved improvement through higher than expected revenues. In Slovakia, where revenue growth was also well above expectations (as a consequence of accelerated consumption before the increase of excise duties and taxes announced for 2008), the improvement in the fiscal position was less pronounced since additional consumption occurred at state and local levels at the same time. On the other hand, Slovenia was one of the countries where better improvement in the fiscal position than foreseen in the Stability Programme from 2006 was not exclusively ascribable to revenue growth – which

was above expectations – but also to lower-than-planned expenditure.[4] Expenditure growth was significantly slower than expected in Malta, which managed to reduce the general government deficit more than expected by considerably reducing investment expenditure on having lower revenues than planned (partially also because of insufficient absorption of EU funds). Ireland, Greece and Belgium, on the other hand, recorded an unexpected deterioration in the general government balance in relation to forecasts.

According to the Commission 2008 spring forecasts, the process of fiscal adjustment observed in the past several years is likely to come to a standstill and to reverse. The predominant view reflected in the vast majority of public and private macroeconomic forecasts is that in 2008 economic growth is likely to ease. Against the background of less favourable cyclical conditions, sustaining the current trends in public finance will represent the key challenge for fiscal policy in the coming years.

[4] Among the countries where the improvement of fiscal balance was due to lower than planned expenditure, Luxembourg showed the highest improvement, but the outcome was mainly the result of a data revision from 2005.

2. Fiscal development and policy in Slovenia

2.1. Budget aggregates of the general government sector[5]

In 2007, the lowest general government deficit since 2000 was recorded. The deficit of the general government sector compared to gross domestic product has fallen gradually and stood at 0.1% of GDP in 2007. In relation to the previous year, the deficit fell by 1.1 p.p., since total nominal general government revenue increased considerably more than total general government expenditure, while growth in both categories lagged behind GDP growth.

Against the backdrop of strong economic growth, the share of general government total revenue and total expenditure in GDP fell in relation to the previous year. The share of general government revenue, which has been very stable since 2000 and was on average approximately 44% of GDP, fell by 0.9 p.p. in 2007, and at 43.2% of GDP recorded the lowest level since 1995. The share of general government expenditure after 2001, when it was the highest in the last decade (48.1% of GDP), gradually declined to 43.3% of GDP last year, which was the most significant reduction in relation to the previous year. A considerable reduction in general government expenditure contributed to a significant improvement in the fiscal position in the past year.

Table 2: **Revenue, expenditure and balance of the general government sector as a % of GDP**

	2000	2001	2002	2003	2004	2005	2006	2007	Change 2006–2007, in p.p.
Total revenue as a % of GDP	43.6	44.1	44.6	44.4	44.2	44.5	44.1	**43.2**	**-0.9**
Total expenditure as a % of GDP	47.4	48.1	47.1	47.1	46.5	46.0	45.3	**43.3**	**-2.0**
Net lending (+)/net borrowing (-) as a % of GDP	-3.8	-4.0	-2.5	-2.7	-2.3	-1.5	-1.2	**-0.1**	**-1.1**

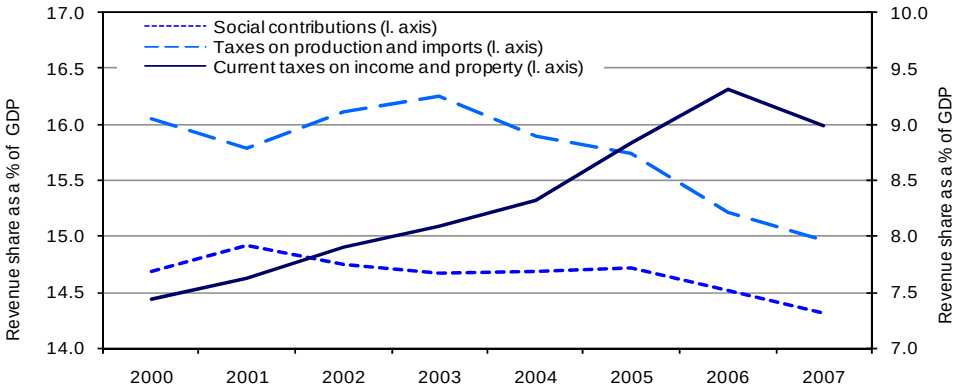
Source: Statistical Office of the Republic of Slovenia (SORS), Main Aggregates of the General Government 2004–2007, 2000–2003 Non-financial sector accounts, calculations by IMAD

In 2007, growth in general government revenue was slightly slowed by tax reform, but as a result of strong economic activity, tax proceeds were higher than expected. Last year, more important revenue categories as well as total general government revenue grew at a slower pace than economic activity, which led to a reduction of their share in GDP. Due to the amended tax legislation in the field of personal income tax and corporate income tax (see Section 3.2), the share of current tax on income and property fell by 0.3 p.p.. The share of revenue from social security contributions, which last year grew faster than other government revenue due to an increase in the number of wage earners, was also smaller (by 0.2 p.p.). Because of the effect of gradual payroll tax reduction (see Section 3.2), the share of tax on production and imports also fell (by 0.3 p.p.). The faster growth in accrued excise duties compensated the moderate growth in accrued VAT due to slow real growth in private and government consumption and, to a lesser extent, faster growth of imports of goods and services. Revenues from other current transfers fell as well (by 0.3 p.p.). Only non-tax revenues, namely interest

[5] The analysis enables comparison with the trends in the EU since it is based on the national accounts methodology ESA-95, available for Slovenia from 1995 on. ESA-95 enables a broader view of the economic role of the government as a whole.

receivable (by 0.1 p.p.) and revenue from capital transfers (by 0.2 p.p.), increased their share in GDP.

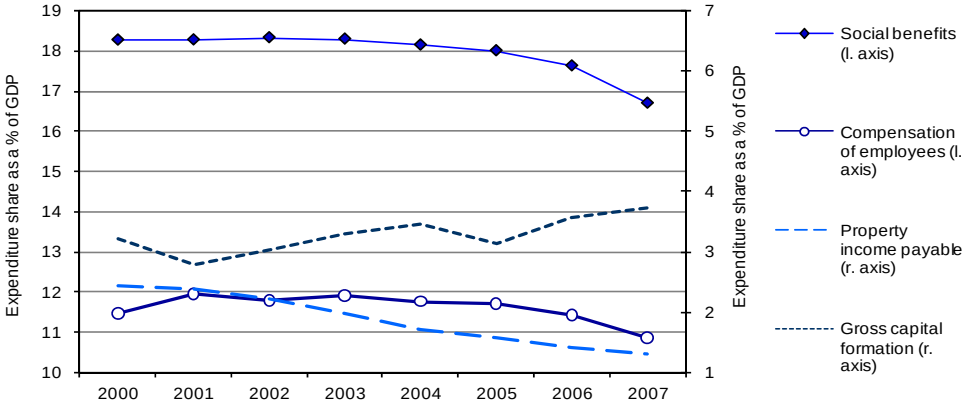
Figure 3: **Changes in the shares of revenue items of the general government sector**



Source: SORS, Main Aggregates of the General Government, calculations by IMAD

In 2007, general government expenditure grew significantly slower than in previous years despite favourable macroeconomic conditions, partly also due to expenditure rationalisation. The total share of general government expenditure in GDP decreased in relation to the previous year by 2 p.p., the sharpest decline after 2001. The share of social benefits in cash suffered the largest reduction (by 0.9 p.p.) due to the introduction of a uniform mechanism for their alignment with inflation (except pensions). The share of compensation of employees also declined considerably (by 0.6 p.p.) due to a decelerated growth rate in the number of employees and slow growth of wages per employee in the public sector in 2007. Compared to 2006, the share in GDP also decreased for intermediate consumption (by 0.3 p.p.) and grants (0.2 p.p.). The share reduction was smaller for interest payments (up to 0.1 p.p.), while the share of other current and capital transfers did not change.

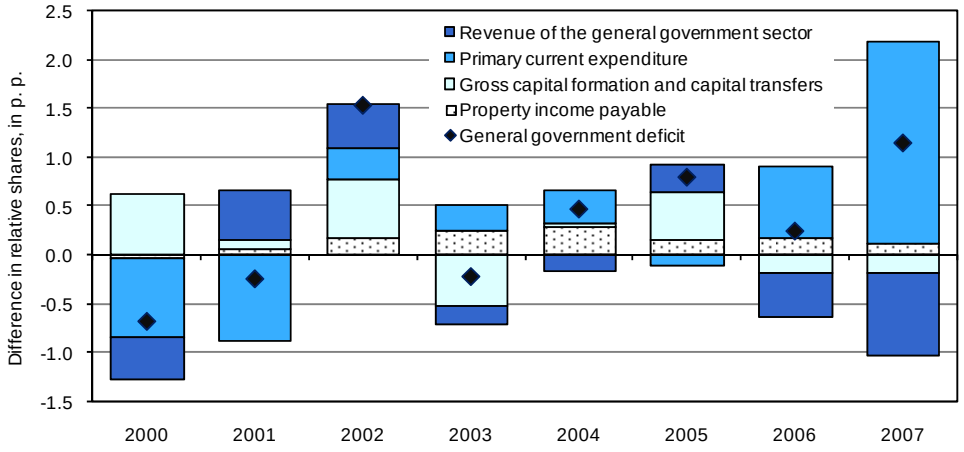
Figure 4: **Changes in the shares of general government expenditure items**



Source: SORS, Main Aggregates of the General Government, calculations by IMAD

Lower general government expenditure made a crucial contribution to the highest recorded deficit reduction since 2003. Primary current expenditures decreased by 2.1 p.p. and property income payable by 0.1 p.p., while capital transfers and investment increased by 0.2 p.p., indicating more growth-oriented general government expenditures in 2007. General government revenue also decreased last year, which meant a lowering of the tax burden (see Section 3.2), but also limited the general government deficit reduction. Since expenditure reduction in the general government sector was significantly higher compared to revenue reduction, the general government deficit nevertheless decreased considerably.

Figure 5: **Contributions to changes in the general government deficit**



Source: SORS, Main Aggregates of the General Government, calculations by IMAD
Note: Positive change in a relative deficit share means a deficit reduction in the current year compared to the previous year. An increase in expenditure and a decrease in revenue are shown as a negative value, since they contribute to a widening of the deficit.

Last year, as well as in the previous year, the general government deficit was generated mainly at the central government level.[6] The deficit fell from 1.2% to 0.3% of GDP compared to the previous year. Local government units concluded 2007 with a balanced position, while social security funds had a surplus of 0.2% of GDP.

Table 3: **Net borrowing of the general government sector by subsector (as a % of GDP)**

	2000	2001	2002	2003	2004	2005	2006	2007
Net borrowing of the general government sector (deficit)	-3.8	-4.0	-2.5	-2.7	-2.3	-1.5	-1.2	-0.1
Of which:								
Central government	-3.3	-3.8	-2.2	-2.5	-2.1	-2.2	-1.2	-0.3
Local government	0.0	0.0	-0.2	-0.1	-0.1	0.0	-0.1	0.0
Social security funds	-0.5	-0.2	-0.1	-0.1	-0.1	0.8	0.1	0.2

Source: SORS, Main Aggregates of the General Government 2004–2007, 2000–2003 Non-financial sector accounts, calculations by IMAD

[6] According to the Standard Classification of Institutional Sectors (SKIS), central government level includes direct budget users, government funds and other central government units.

2.2. Cyclical and cyclically adjusted general government balance

Based on a breakdown of budget aggregates into cyclical and cyclically adjusted components, the orientation of fiscal policy can be estimated. The general orientation of fiscal policy in relation to the response of revenue, expenditure and consequently fiscal balance to changes in the economic cycle is more evident once aggregate developments are cleared of cyclic effects.[7] The cyclically adjusted or structural balance[8] shows what kind of budgetary results could be achieved simply through the operation of fiscal policy measures, i.e. without the influence of cyclical conditions.[9] Comparison of the change in the cyclically adjusted balance and output gap between individual years indicates the orientation of fiscal policy. The reduction of the cyclically adjusted deficit in a period of accelerated economic growth thus indicates the restrictive orientation of fiscal policy.

In 2007, the cyclically adjusted deficit halved and was 0.4 p.p. higher than the actual deficit. Since 2000, together with the actual deficit, the cyclically adjusted deficit has also been gradually falling with the cyclical variation in economic activity. According to available estimates, the output gap closed in 2007, when actual economic growth exceeded potential growth. The improvement in the fiscal stance was ascribable to cyclic as well as structural factors. Apart from a reduction in the relatively expressed nominal deficit, the cyclically adjusted deficit, reflecting the effects of structural adjustments, also declined (by 0.5 p.p. compared to the previous year). We estimate that with the positive output gap, last year's actual deficit (-0.1% of GDP) was lower than the cyclically adjusted deficit (-0.45% of GDP). Slovenia therefore reached its mid-term fiscal objective – expressed as a structural or cyclically adjusted deficit – set at 1% of GDP (for the concept and recent developments regarding mid-term fiscal objectives see Box 2).

Table 4: **Actual, cyclical and cyclically adjusted general government balance, as a % of GDP**

	Output gap	Actual balance	Cyclical balance	Cyclically adjusted balance	Primary balance
2000	0.6	-3.8	0.2	-4.0	-1.3
2001	-0.4	-4.0	-0.2	-3.9	-1.6
2002	-0.7	-2.5	-0.3	-2.2	-0.3
2003	-1.9	-2.7	-0.8	-1.9	-0.7
2004	-1.7	-2.3	-0.7	-1.5	-0.5
2005	-1.9	-1.5	-0.8	-0.6	0.1
2006	-0.5	-1.2	-0.2	-1.0	0.2
2007	0.9	-0.1	0.4	-0.5	1.2

Source: Mićković, S. (2008): Assessment of the fiscal stance in Slovenia
Note: [1]In accordance with the methodology of the European Commission, estimates of cyclically adjusted deficit derive from the calculations of output gap based on the production function. This asserted itself as the most appropriate method of detecting potential GDP growth and the elasticity of expenditure and revenue to changes in the business cycle, despite some methodological deficiencies (e.g. as regards uncertain estimates of capital stock).

[7] Cyclicality is measured by the difference between actual and potential output, i.e. the output gap.
[8] Structural balance might differ from the cyclically adjusted balance for the effects of exceptional factors (e.g. the EU presidency). Our analysis is based on the calculations of a cyclically adjusted balance.
[9] The cyclically adjusted balance shows the fiscal balance under the assumption that actual GDP growth equals potential growth.

Box 2: **New medium-term fiscal objectives within the framework of the renewed Stability and Growth Pact**

In the run-up to the EMU, the Stability and Growth Pact was adopted in 1997 (hereinafter: Pact), which represents a mechanism for the coordinated implementation of fiscal policies of Member States with the common currency. Since its introduction, it has been obvious that the Pact has deficiencies, which became very obvious with the enlargement of membership and the growing differences between Member States. A decision on reforming the Pact was adopted which should enable more efficient coordination of fiscal policies and discourage countries from violating the provisions of the Pact.

The reform of the Pact, which was formally endorsed at the meeting of the European Council in March 2005,[10] was focused on increasing the economic rationale of fiscal rules[11] and commitment to compliance at national level. The new Pact therefore acknowledges the greater importance of economic conditions in procedures, monitoring the acheivement of fiscal objectives and reduction of fiscal deficits in favourable economic conditions, while at the same time putting more emphasis on the level of public debt and sustainability of public finance. The reform enabled better consideration of actual economic conditions and structural reforms in individual countries. The changes introduce the implementation of differentiated medium-term fiscal objectives and tolerance allowed on the route to adjustment. These should be implemented gradually, in two steps. In the first step, the Member States presented their medium-term fiscal objectives[12] for the first time in their Stability and Convergence Programmes for 2005, where they already took into consideration the lowest benchmark reference, which represents the minimum requirement as to the value of the medium-term objective.

The second step anticipates that differentiated medium-term fiscal deficits for each country will be calculated taking into consideration implicit liabilities.[13] As opposed to the calculation in the first step, which only considers past trends, the calculation approach in the second step is focused more on future trends, which is important in ensuring and preserving the medium- and long-term sustainability of public finance. The European Commission submitted a proposal for the methodology of calculating medium-term fiscal objectives to Member States for discussion. The quantitative assessment of the sustainability of public finance and setting medium-term fiscal objectives on the basis of sustainability criteria should be supplemented by a qualitative assessment which will additionally consider the reliability of projections for expenditure linked to ageing, as well as the complete scenario of future economic trends based on the envisaged economic policy measures.

The European Commission established three basic approaches for the calculation of medium-term fiscal objectives, which are briefly described below as approaches A, B and C (for details see Appendix). The first two are entirely based on synthetic indicators of long-term fiscal sustainability, while the third approach allows for the inclusion of sustainability components that are not sufficiently included in the established indicators.

[10] Legal basis: Council Regulation EU 1055/2005 and Regulation 1056/2005.
[11] Quality analysis of fiscal rules according to the Kopits-Symanski criteria shows that the reform brought positive changes, but the complexity of rules and their consistent and objective assessment is becoming a problem; at the same time the issue of feasibility of sanctions remains problematic (Bednaš, 2006).
[12] Calculations were prepared in compliance with the methodology, which takes into consideration the level of public debt, potential economic growth and safety margin.
[13] Implicit liabilities comprise those liabilities which arise in the future and are linked mainly to population ageing, and contingent liabilities which do not necessarily have a basis in legislation or a contract but are part of the programme requirements of influential interest groups.

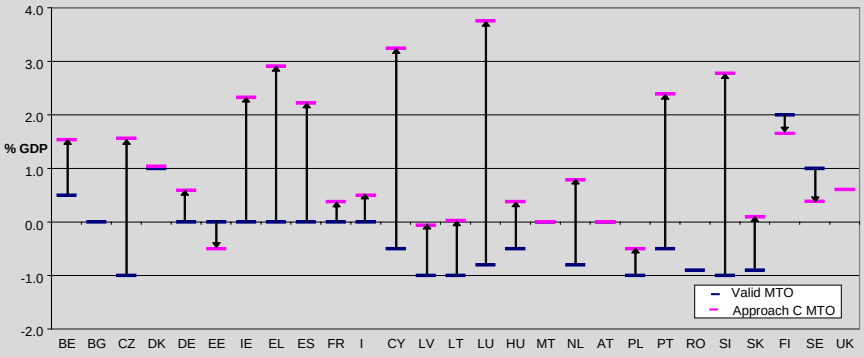
Approach A is based on frontloading the adjustment to the medium-term objective. The new medium-term objective for Slovenia, calculated according to this approach, is a general government surplus of 6.1% of GDP, which with regard to the existing framework of public finance is a completely unrealistic objective of fiscal policy. Compared to the existing medium-term objective, the new objective calculated on the basis of this method requires a considerably more ambitious fiscal policy, also for other Member States.

Approach B is based on the principle of gradual adaptation and allows taking into consideration different fiscal positions in individual Member States. The new medium-term objective for Slovenia, calculated on the basis of approach B, is a general government surplus of 2.8% of GDP.

Approach C is based on the assumption that the process of fiscal adjustment in an individual Member State depends on its specific economic situation and allows that, in addition to the current level of government debt, other sustainability factors are also taken into consideration. In the calculation of the new medium-term objective for Slovenia, the European Commission has not presumed any other important sustainability factors; therefore, the medium-term objective calculated on the basis of this approach is the same as for Approach B, i.e. a general government surplus of 2.8% of GDP.

The new medium-term fiscal objectives are, regardless of the approach used, higher than the current ones for most Member States.

Figure 6: **Valid medium-term fiscal objectives (MTOs) and proposals for new objectives as per Approach C**



Source: ECFIN/C2/REP/52865/07 REV

Each of the proposed approaches is debatable, in view of the fact that in choosing a reference value it places countries with a low government debt level, such as Slovenia, in an unequal position with regard to countries with high debt levels. This could be eliminated by taking into consideration the difference between the existing government gross debt level and the allowed maximum level of government debt. Countries with high indebtedness should therefore have a higher primary balance than those with lower debt levels. The proposed approach puts more emphasis on the current fiscal position, with a high probability that the contingent liabilities will become real. In addition to fulfilling the enforced requirements, it would also enable avoiding bad allocations of funds in the medium-term arising from considerable uncertain liabilities in the future. The new medium-term objective for Slovenia, calculated on the basis of this approach, would not be higher than 1% of GDP, taking into account the government debt outstanding in the ensuing years.

However, such an approach could not eliminate other deficiencies of the approaches described above, in particular:
- the excess weight of actual liabilities at the expense of contingent liabilities;
- the great uncertainty of expenditure assessments related to ageing;
- the reduction of contingent liabilities arising from reforms of social security systems but at the expense of endangering well-being, which increases other contingent liabilities.

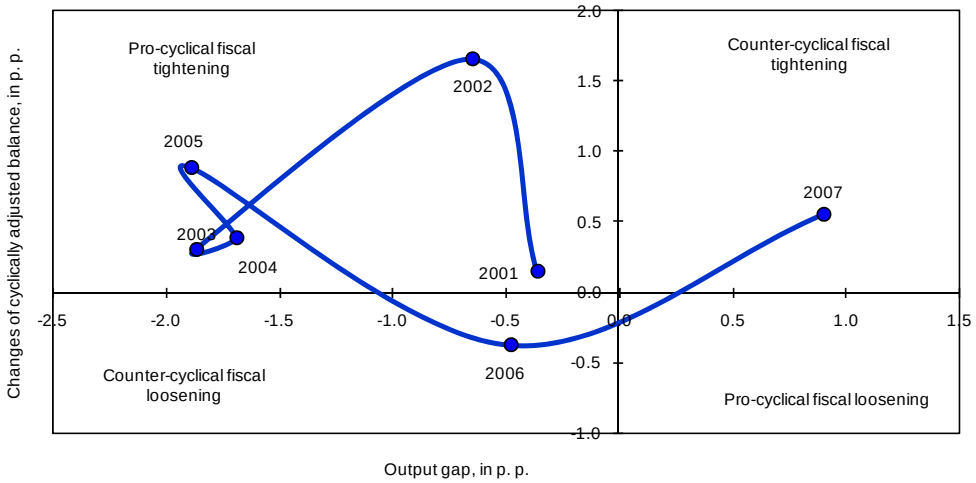
Setting up conditions for the long-term sustainability of public finance should begin immediately and be implemented gradually. In view of feasibility, the key factors are especially:
- reducing the period for which we establish contingent liabilities for the needs of determining medium-term objectives to, for example, ten years;
- adjusting the medium-term objectives for the period of ten years every four years;
- determining medium-term objectives which enable compliance with the reference value at 3% of GDP.

Comparison of the dynamics of the cyclically adjusted deficit and output gap shows pro-cyclical or counter-cyclical orientations of fiscal policy. Changes of the cyclically adjusted balance in consecutive years indicate the orientation of fiscal policy, i.e. fiscal impulse. Comparing it to the output gap in the same period, which shows changes in the business cycle, we can estimate the cyclical dimension of fiscal policy, i.e. fiscal stance. In Figure 7, we can define four quadrants with regard to changes in fiscal impulse and output gap, which determine the fiscal stance. Fiscal policy is counter-cyclical if the combination of both parameters lies in the first or third quadrant. This means that fiscal policy, when economic growth falls below its potential, responds expansively; when actual growth exceeds the potential growth of GDP, it responds restrictively. The combination of both parameters in the second or fourth quadrants indicates a pro-cyclical fiscal policy, meaning that when economic growth falls below potential, the fiscal policy responds restrictively; when actual growth exceeds the potential growth of GDP, fiscal policy is also expansive. A pro-cyclical orientation means that fiscal policy does not allow for automatic stabilisers to operate, which results in, for example, expenditure changing in accordance with changes in economic growth, and not as planned. This means that in the case of economic growth which is higher than initially planned, pro-cyclical budget revenues are used to finance reductions in taxes and increased expenditure, and not to reduce the deficit.

In 2007, fiscal policy was counter-cyclically restrictive for the first time since 2000. Based on a comparison of dynamics of the cyclically adjusted balance and output gap in the period 2000–2007, we assess that fiscal policy in the first five years was restrictive, but pro-cyclical (see Figure 7, where in presenting the transition of the cyclical orientation of fiscal policy from the second to the first quadrant, the points are denser in the second quadrant). In the period 2001–2005, when actual economic growth was lower than its potential, the trend of fiscal expenditure followed the macroeconomic situation. In the period when the main priority of economic policy was to fulfil the requirements to adopt the euro, fiscal policy restricted the activity of fiscal stabilisers. The general government deficit therefore remained below reference value, but fiscal policy acted restrictively. Since 2006, when the output gap started to close, fiscal policy has been counter-cyclical. At first it was slightly expansive – the cyclically adjusted deficit of 2006 increased (per available assessments by 0.4 p.p.) – but the improvement last year (by 0.5 p.p.) shows that fiscal policy again became restrictive. The increase of the fiscal impulse

under conditions of a positive output gap was an appropriate response of fiscal policy in terms of its stabilisation role (shift to the first quadrant in Figure 7). The fiscal adjustments were therefore in compliance with the provisions of the Stability and Growth Pact, according to which fiscal policy should be restrictive in conditions of high cycles.

Figure 7: **Cyclical orientation of fiscal policy**



Source: Mićković, S. (2008): Assessment of fiscal position in Slovenia
Note: Positive fiscal impulse, for example, means an improvement of the cyclically adjusted deficit in the current year in comparison to the previous year. The varying distances of separate points from the axes shows fiscal policy intensity.

This year, fiscal policy should preserve its counter-cyclical orientation. The most recent assessments based on data from the adopted supplementary budget for 2008 indicate that the ratio between actual and cyclically adjusted balance this year will be approximately at the level of last year. With an anticipated reduction in the positive output gap, this means that fiscal policy remains counter-cyclically oriented. At the same time, we may expect that changes in tax legislation[14] will lessen the fiscal impulse; recent assessments show that the cyclically adjusted deficit will improve only slightly, although the output gap will remain positive.

2.3. Financial flows between Slovenia and the EU budget

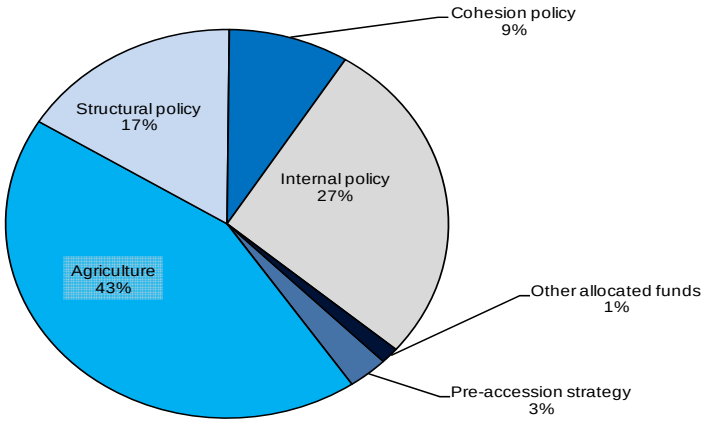
In 2007, Slovenia was a net contributor of funds to the EU budget for the first time since joining the EU. According to the Ministry of Finance, last year the absorption of funds from the EU budget was very modest, and at the same time expenditure from its own traditional resources was higher than expected.[15]

[14] Amendments of laws passed in January this year as part of measures to reduce the consequences of higher inflation on the population's well-being, among other things introduced additional general tax relief in personal income tax for persons with taxable incomes up to EUR 9,000 and increased social transfers.
[15] Traditional own resources (payments originating from customs duties, import duties and special taxes on the import of agricultural products and foodstuffs) are treated as EU budget revenues in the strict sense collected by Member States, whereby they retain a quarter of the funds as reimbursement for collection costs.

Contributions from customs duties[16] were much higher than expected and contributions from VAT were slightly higher, which together greatly exceeded the planned contributions in the budget for 2007. The highest contribution to the EU budget represented contributions based on gross national income with a 55.3% share.

Total absorption of funds from the EU budget was greatly reduced in 2007. Last year, the absorption of funds was much lower than expected, especially in the field of structural and cohesion policies, where delays occured in absorbing funds from the new financial perspective.[17] Until last year, Slovenia was among the most successful new Members, as it utilised almost 70% of the funds to which it was entitled in the previous financial perspective.[18]

Figure 8: **Structure of funds allocated from the EU budget to the state budget in 2007**



Source: Ministry of Finance

European Commission data on inflows and outflows of EU budget funds show that last year Slovenia remained a net recipient of funds, but with the lowest surplus thus far. Funds received from the EU budget last year were again higher than contributions, which represented 1.09% of GDP, but the surplus was the lowest since 2004. Differences between Commission and Ministry data on funds allocated from the EU budget occur because the Ministry data does not include funds allocated to recipients in Slovenia with whom the European Commission concludes direct agreements. Advance payments from Structural Funds and funds for rural development, which are already EU budget expenditure, become revenue in the Slovenian budget only when the requirements are fulfilled.[19]

[16] This also meant higher budget revenue.
[17] In 2007, programme documents were adopted and a new institutional structure formed for the implementation of programmes in the new programme period 2007–2013; actual absorption is expected to increase in 2008.
[18] In December 2005, a new financial perspective was adopted for 2007–2013. Based on the new financial perspective, in a period of seven years Slovenia is entitled to EUR 5,128m (current prices), and up to EUR 712.7m of this amount in 2008. Slovenia may utilise funds from the previous financial perspective allocated in 2006 until the end of this year.
[19] The funds are shown among state budget revenues only when the costs related to a certain project actually occur, and are at the same time shown as expenditure in the state budget.

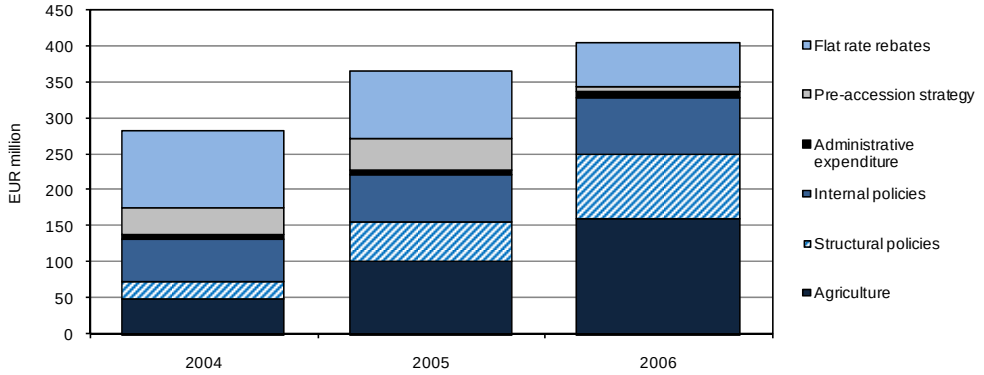
Table 5: **Net position of the Republic of Slovenia with respect to the EU budget 2004–2007**

	in EUR m			
	2004	**2005**	**2006**	**2007**
Total funds received from the EU budget	282.0	366.2	406.1	390.1
Total payments to the EU budget	170.4	274.7	279.1	359.4
Net position – accounting definition*	111.6	91.5	126.9	30.7
*Net position** (operating budgetary balance)*	*109.7*	*101.5*	*142.7*	*88.5*

Source: EU Budget 2007 Financial Report
Notes:
* Net position based on accounting definition is calculated as the difference between total receipts and total payments.
** Net position is calculated as the difference between allocated and contributed funds, excluding administrative expenditure, and taking into account adjusted national contributions based on the UK rebate.

In the period since joining the EU, the structure of financial flows between Slovenia and the EU budget has changed. Slovenia has obtained the majority of funds on the basis of the Common Agricultural Policy, and the majority of remaining funds for implementing internal policy. In the past two years, the absorption of funds from cohesion funds and for programmes within common agricultural policy greatly increased, while the share of funds from pre-accession strategy declined. That is, within the framework of the pre-accession strategy, Slovenia received funds only for the PHARE and ISPA programmes, while the SAPARD programme was completed in 2005, and the measures of this programme were financed as part of the Common Agricultural Policy. We estimate that structural changes also occurred last year, because Slovenia was entitled to flat rate rebates on the basis of the Accession Treaty only until the end of 2006.

Figure 9: **Structure of funds received from the EU budget 2004–2006**



Source: EU Budget 2006 Financial Report

The supplementary budget for 2008 anticipates that Slovenia will be a net recipient of EU budget funds at the end of year. In the first half of this year, Slovenia was a net contributor of funds to the EU budget. With regard to trends in recent years, we may expect that higher absorption of funds from the EU budget will occur only in the second half of the year. Under the assumption that this year some of the funds planned to be utilised last year will be absorbed in addition to the funds planned for this year, Slovenia's net position in the EU budget will again be positive in 2008.

2.4. General government debt and debt guaranteed by the Republic of Slovenia

At the end of 2007, the share of general government consolidated debt reached its lowest level thus far, with 24.1% of GDP. Compared to 2006, the debt ratio was lower by 3.1 p.p., which was the most significant drop since 2000, when the share of the debt started to decrease.[20] Managing government debt, which comprises replacing expensive forms of borrowing with cheaper alternatives, and debt redemption, had a positive impact on the process.[21] The further reduction of the effective interest rate resulted in lower budgetary funds for payments of interest on accumulated debt and therefore had an impact on the reduction of the budget deficit. Debt also decreased more than expected last year because of a lower government deficit than expected.

Important debt reductions resulted from early debt repayments. Since the end of the 1990s, a strategy of debt redemption has been implemented in order to reduce the costs of debt service in the long-term and achieve higher liquidity. After joining the EMU, this process could intensify due to entering a more developed financial market. In 2007, debt redemption amounted to EUR 1bn, which was the highest amount since 2004. Government debt of EUR 76m was prepaid by using some of the privatisation fees from the sale of the second largest Slovenian bank Nova Kreditna Banka Maribor – NKBM and the Slovenian steel company Slovenska industrija jekla – SIJ.[22]

While replacing expensive borrowing with cheaper alternatives, the favourable debt structure also contributed to reducing the burden of debt service. Since joining the EMU, the majority of debt is denominated in EUR. In recent years, borrowing to a large extent became long-term, with mainly fixed interest rates. In 2007, debt with a variable interest rate represented only around 2% of total debt.

A simulation shows that the debt financing burden would increase with a rise in interest rates and slower economic growth. With regard to term, currency and interest structure, debt is sensitive to changes in ECB interest rate levels, especially in the long-term, while it is quite stable in the short- and medium-term. A simulation of debt sensitivity to changes in interest rates[23] shows that if ECB interest rates rise by 100 basis points in 2008, the costs of debt repayment would increase by 0.04% of GDP in 2009. A simulation of debt sensitivity to changes in economic growth indicates that, if GDP growth is slower by 1 p.p. per year in 2008 and 2009, the share of general government debt would increase by 0.4% of GDP in 2009.

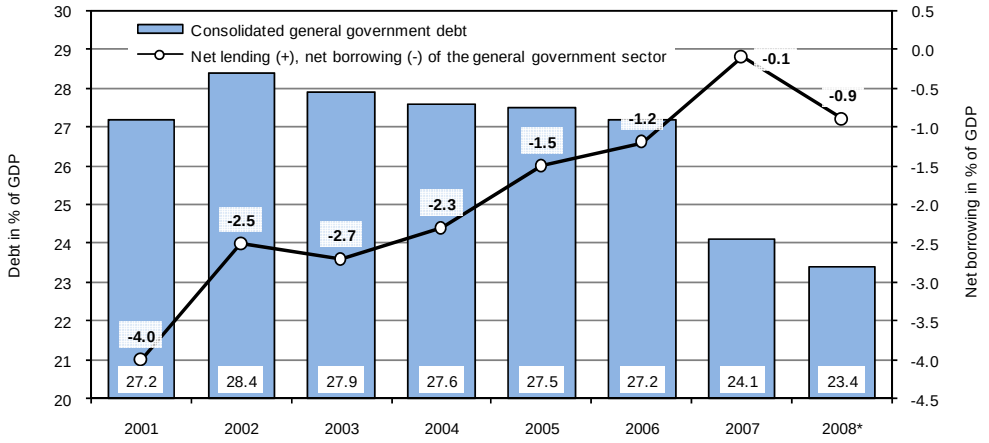
[20] With the revision of total general government consolidated debt for the period 2001–2006, the outstanding debt as a share of GDP at the end of 2006 accounted for 27.2% of GDP, about 0.5 p.p. less than before the revision. Last year, the Ministry of Finance published revised data following total consolidation within and between subsectors. The revision was made for the whole period from 2001 on. At the beginning of this year, another revision was made for the years 2005 and 2006, which resulted in a slight increase of the debt for these two years. However, the revised data resulted in a decrease of the general government debt outstanding for the entire revised period. Local government debt was revised upwards after the inclusion of data on leasing for the period up to 2005. The first revision was published in the Report on government debt and deficit, submitted to the European Commission in October 2007 and the second revision in the Report submitted in April 2008.

[21] State budget debt in the period 2001–2006 decreased relatively faster than general government debt, and by the end of 2007 it fell to 22% of GDP.

[22] The supplementary budget for 2008 anticipates that also this year a part of the inflows from the privatisation of NKBM and SIJ will be used to reduce government debt.

[23] Stability Programme, December 2007.

Figure 10: **General government debt and deficit as a share of GDP**



Source: Ministry of Finance, 2008
Note: *Forecast for 2008 from the Debt and Deficit Report, April 2008.

The debt of the central level of the government represents the largest share of debt. In the past three years, this share has been at around 97% of total unconsolidated debt, or 99% of total consolidated debt. Borrowing at local government level is restricted by two fiscal rules: in a certain year, it may not exceed 20% of the revenue of the previous year, and the costs of debt servicing may not be higher than 5% of realised revenue in the previous year.[24] The debt of the social security funds (the pension fund - ZPIZ and the health fund - ZZZS), which was transferred in its entirety to the state budget in 2005, at this moment represents only the borrowing balance of ZZZS in the form of leasing.

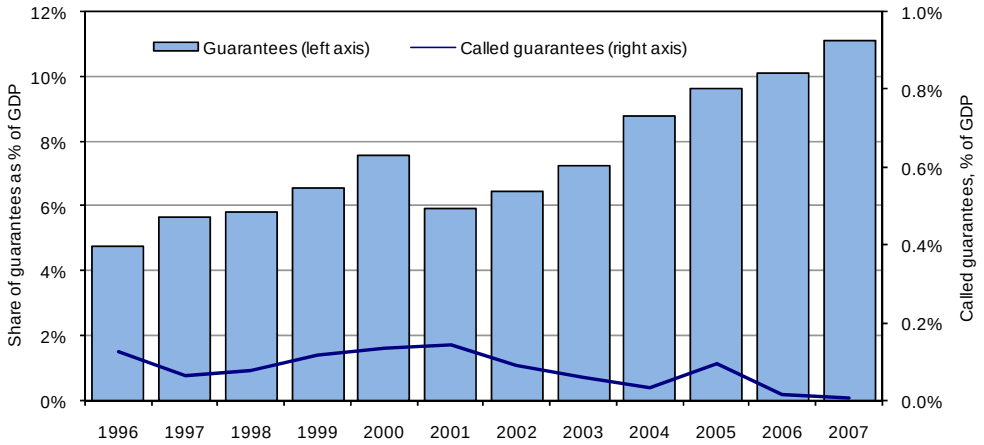
In 2007, the share of guarantees increased again, and at the same time the share of called guarantees decreased. The share of called guarantees, which until 2000 stayed at around 2% of total guarantees, has decreased[25] considerably in recent years and amounted only to 0.05% of total guarantees in 2007. In terms of share of GDP, this is only 0.1%. With regard to the structure of guarantees, it is not very likely that larger guarantees will be called in the coming years. The largest share of guarantees in 2007 went to companies in the field of transport and communications (66.3%) and in financial intermediation (28.5%).

In April 2008, two guarantees were issued/signed for a total of EUR 675m. The first guarantee was issued on the basis of the Act Regulating the Guarantee of the Republic of Slovenia for the obligations of the highway company DARS from 2005, in the amount of EUR 145m. The second guarantee, for EUR 530m, was issued to SID Banka on the basis of the Act Governing the Insurance and Financing of International Commercial Transactions from 2004. In April this year, the guarantee to the Ecological Fund (Ekološki sklad RS) also became valid. A contract for liabilities in the amount of EUR 30m was signed in September last

[24] The servicing of debt may increase by an additional 3% of last year's revenue to finance investment projects in education, dwellings, water supply and waste disposal and for projects co-financed by EU funds. The restricted amount of borrowing includes leasing, trade credits and any other contractual engagement which would represent the actual indebtness of the local budget (Financing of Municipalities Act, Official Gazette, No 123/2006).
[25] Except in 2005, when two large guarantees were called, but they were the first and only ones thus far for these two companies.

year, but it entered into force on the date of EIB confirmation on receipt of ratification.

Figure 11: **Debt guareented by the Republic of Slovenia and guarantees called**



Source: Ministry of Finance, 2008
Note: Data on guarantees is based on the GFS methodology.

2.5. Long-term sustainability of public finance

Considering current demographic trends, the most important challenge for fiscal policy in the next decades will be to maintain the sustainability of public finance. Population projections by Eurostat[26] show that by 2050 the share of the population over 65 years of age will rise quickly in Slovenia, and the share of the population from 15 to 64 years of age capable of work will fall. Based on the baseline scenario of population projections, the old-age dependency ratio (the size of the ageing population relative to the number of people of working age) is forecast to increase from 21.7% in 2005 to 55.6% in 2050.

Due to the extremely high growth of expenditure linked to ageing, Slovenia is among the more exposed EU countries in terms of ensuring the long-term sustainability of public finance. In its last assessment of long-term sustainability, the European Commission placed Slovenia in the group of countries most exposed to public finance risk caused by population ageing, along with Greece, the Czech Republic, Hungary and Cyprus. The estimated growth in expenditure linked to ageing by 2050 is between 9.9% BDP and 10.4% BDP (see Figure 6), whereby none of the assessments considers reducing the initial balance of actual obligations in past years. The decline occurred because of the simultaneous effect of two factors after the implementation of tax reform: growth in wages lagged behind growth in productivity, and at the same time the tax reform caused a delay in the implicit taxation of pensions.[27] Under the circumstances of expected demographic trends and under the assumption of an unchanged economic

[26] In 2008, Eurostat prepared the EUROPOP2008 demographic projection for the analysis of the fiscal effects of ageing. Changes in the age structure of the population were recorded compared to the previous EUROPOP2004.
[27] The impact of the performed valorisation was therefore lower than that calculated in projections of expenditure.

environment and policies, public debt would start to increase after 2015, concurrent with an increase in general government expenditure linked to population ageing, and would become unsustainable by 2050.

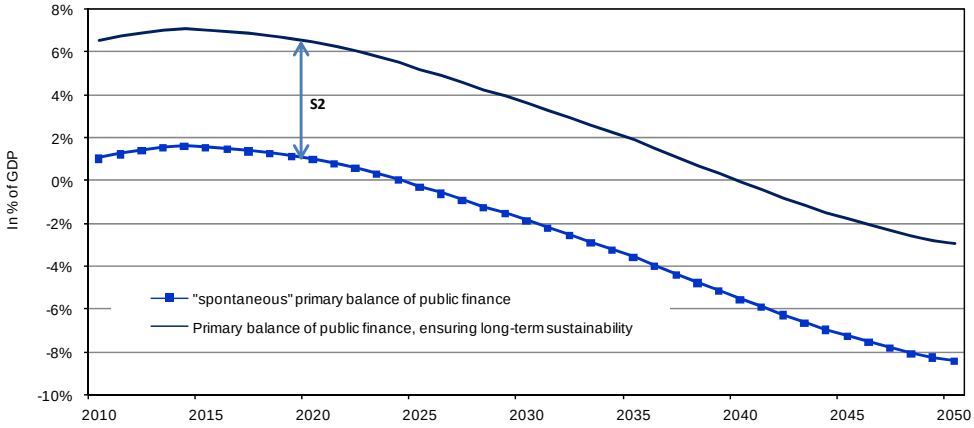
Table 6: **Projections of fiscal indicators for the long-term sustainability of public finance**

SLOVENIA	Changes in expenditure linked to ageing		Sustainability gap		Debt dynamics				Required primary balance
	Change from 2010 to		S1	S2	2007	2010	2030	2050	
	2030	2050							
European Commission	4.6%	9.9%	3.0%	6.5%	25.6%	23.0%	45.0%	227.0%	7.3%
Stability Programme – update 2007	5.0%	10.4%	1.6%	5.5%	25.3%	21.1%	16.0%	164.1%	6.6%

Source: Stability Programme 2007, European Commission: Slovenia – Macro Fiscal Assessment, An Analysis of the November 2007 Update of the Stability Programme, 2008.
Note: Primary balance, increased by the value of indicator S1, ensures achieving the reference debt margin (60% of GDP) in 2050, if the course of policies does not change during this time. Primary balance, increased by the value of indicator S2, ensures fulfillment of an inter-temporal budget constraint over an unlimited time horizon, if during this time policies remain unchanged.

Indicators S1 and S2, which measure the budget adjustment required to ensure the sustainability of public finance, confirm that the pressure on public finances is considerable. Based on recent calculations,[28] the value of parameter S1 is 1.6% of GDP, which means that the primary balance should be higher by 1.6 p.p. per year until 2050 in order not to exceed the reference debt margin (60% of GDP) in 2050. The value of parameter S2 is 5.5% GDP, which means that the primary balance in the coming years should be 5.5 p.p. higher per year in order to remain within the intertemporal budget constraint (see Figure 12).

Figure 12: **Projected fiscal balance with regard to the indicator of long-term sustainability**



Source: Ministry of Finance, 2008

[28] Stability Programme 2007.

Systemic adjustments are necessary to preserve the long-term sustainability of public finance. Increased obligations to finance pensions require the restructuring of general government expenditure and adjustments in the pension system, including the mechanism of pension valorisation and encouraging additional voluntary pension schemes. Immediate changes in the sphere of regulating pensions would reduce the costs of the required adjustment. An additional argument for quick action is that the burden of adjustment would be distributed among generations. Given the expected demographic changes, not only expenditure on pensions will increase, but also expenditure in other fields of public financing, especially healthcare and long-term care. The implementation of economic policy measures in the sphere of employment and productivity, in terms of increasing work activity in old age, may contribute to reducing the pressure of demographic changes on public finance.

3. Fiscal policy and long-term growth

With the efforts to increase economic growth potential in the EU, the development role of fiscal policy has strengthened alongside its stabilisation role. The strategic framework for the coordinated implementation of economic policies in the EU is aimed at higher economic growth and more jobs. Under the pressures of globalisation and unfavourable demographic trends, fiscal policy also assumed more of a development role. If economic growth is a prerequisite for better social inclusion and more jobs, then fiscal policy objectives are important preconditions for growth: greater adjustment capacity to external shocks, the stabilisation role and the long-term sustainability of public finance. Monitoring the quality of public finance is not coordinated among the EU Member States in terms of methodology, so the European Commission has started developing a common framework for measurement and assessment, which after its formal adoption Members should adopt and implement to gain a comprehensive analysis of public finances and their quality.

3.1. Methodological framework for measuring the quality of public finance

The European Commission is placing the quality of public finance in a multi-dimensional framework. The conceptual framework includes elements of fiscal policy and activities in other spheres linked to them which support long-term economic growth. At the centre of the six dimensions remain the required adjustments imposed upon fiscal policy by the Treaty of Lisbon and the Stability and Growth Pact.

The first dimension is defined by the size of general government. This dimension is not necessarily of key importance for the development impact of fiscal policy, as the long-term connection between the scope of government and economic growth is uncertain. Despite a relatively large scope, countries may have a successful fiscal policy by using an efficient tax system, and at the same time ensure the efficient use of public funds.

The second dimension is represented by the size and variability of the government deficit. This is directly reflected by the provisions of the Stability and Growth Pact which are aimed at supporting economic growth by smoothing the business cycle and ensuring the long-term sustainability of public finance.

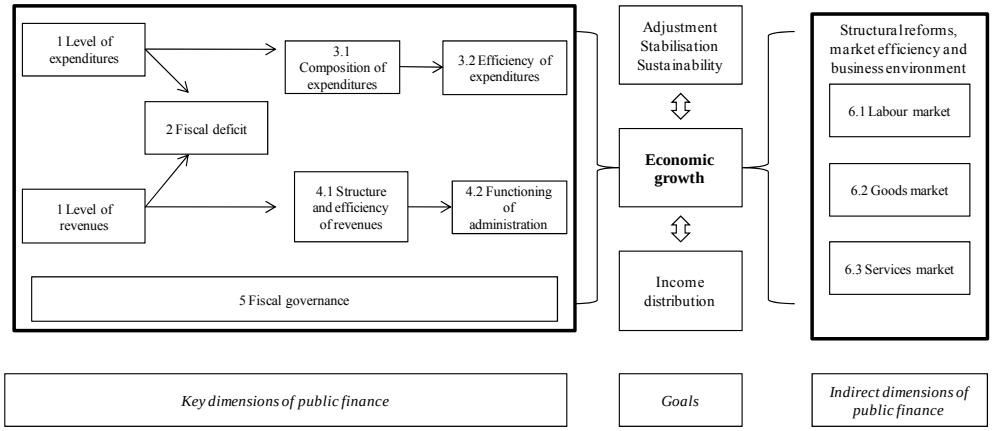
The third dimension comprises the composition and efficiency of government expenditure. In conditions of permanent pressure from increasing obligations (e.g. ageing of the population), in addition to an appropriate composition of government expenditure, it is of key importance to ensure the efficient use of public funds. Surveys on efficiency of public expenditure for education and health, which are most common due to data availability, indicate room for improvement.[29] The

[29] International surveys performed by the International Monetary Fund, based on the DEA (Data Envelope Analysis) methodology, places Slovenia in the group of countries with the lowest efficiency of public spending in health care and education. Efficiency coefficients show that the same result could be achieved with approximately two thirds of the resources, assuming that the resources were used as efficiently as in the most efficient country in the studied sample (IMF, 2006).

contribution of the dimension of the size and structure of government expenditure to economic growth is greater in those countries where the implementation of programmes and measures is supported by fiscal rules on the expenditure side, a results-oriented budget and a firmly established medium-term policy.

The fourth dimension is determined by the structure and efficiency of government revenue. The structure of government revenue reflects the development capacity of the tax system to directly influence the adjustment capacity of the economy. Because of the impact on job supply and the accumulation of capital, a relatively higher share of indirect taxes in the total structure of revenues may have a faster and greater impact on increasing the potential for economic growth; a simple, transparent tax system which ensures more complete coverage of tax collection with lower administrative costs contributes especially to higher efficiency from government revenue.

Figure 13: **Six-dimensional framework of public finance quality for ensuring economic growth**



Source: European Commission, ECFIN: The Quality of Public Finances: a Roadmap for Deriving a Conceptual Framework and Set of Indicators (Note for the EPC Working Group on QPF), Brussels, 1 February 2008

The fifth dimension is fiscal governance, which cuts through all previous dimensions of public finance quality. A modern institutional framework with independent fiscal institutions,[30] clearly defined medium-term fiscal objectives and binding fiscal rules enables greater discipline and thereby reduces fluctuations and contributes to the long-term sustainability of public finance.

The sixth dimension comprises all activities which are outside of but tightly connected to public finance. Adjusting the regulatory and legislative framework as part of structural reforms is essential for good performance in labour, products and services markets, which have an important impact on the better responsiveness of the economy to shocks and long-term trends. Fiscal policy has a

[30] Regimes which, as part of the budget process, delegate responsibility for the planning stage (partly) to institution/s which are organisationally not subordinate to the bodies responsible for the implementation stage – for example, the procedure for preparing the strategic macro-fiscal framework – may be, on the basis of realistic assumptions, more successful in realising the plans (see Report on Quality of Public Finances Issue, 2008).

key role through its impact on the mobility of production factors, labour market participation, wage policy and the business environment.

A multi-dimensional framework of public finance quality is a methodological and statistical basis for comparison between EU Member States. As a lack of data and inappropriate data sources hamper analytical work, records and indicators are currently being thoroughly harmonised,[31] especially in measuring the efficiency of government expenditure, which has an important impact on accelerating economic growth. A comprehensive analysis should include data on inputs, outputs and outcomes, but the complete set of indicators is not yet completely developed. For example, in some areas output indicators are available, but there are no coordinated indicators to measure outcome.[32] Uniformity of procedures to measure efficiency is necessary to improve comparability between countries.

A comprehensive survery of public finance quality for Slovenia has not yet been performed. Separate dimensions are partly addressed in our regular presentation of fiscal developments and policy in the present publication (see especially Sections 2.1., 2.2. and 2.5.), and the analysis is supplemented this time with an attempt to address the efficiency and effectiveness of government revenue and expenditure. Revenue efficiency is analysed in the light of the effects of the latest tax reform; the efficiency of government expenditure is reviewed for two types of expenditure, with regard to the accessibility of data and information and its actuality: state aid and expenditure for social protection.

3.2. Efficiency of government revenue

An efficiency analysis of government revenue assesses the impact of the tax system on the allocation of production factors and, consequently, the stimulation of stable and long-term growth. The tax system determines economic conditions and is an important factor in economic decisions which further influence the allocation of production factors. Key dimensions in the assessment of government revenue efficiency are height and the ratio between tax burden of labour and capital, because of their influence on the allocation of factors and competitiveness of the economy, and the prospect of accelerated economic growth and employment. The assessment of tax system efficiency below is limited to the consequences of the latest tax reform.

Tax changes in 2007 reduced the tax burden. The total burden of taxes and contributions in Slovenia in 2006,[33] measured as a share of GDP, was 39.3%, slightly below the EU average of 41.2%, but it deviated from other countries by having an above-average tax burden on labour and consumption and a below-average tax burden on capital. A tax reform was introduced in 2007 aiming at increasing the competitiveness of the economy and creating a stimulating tax

[31] As part of designing a unified methodological framework for analysing the quality of public finance, the European Commission has started collecting the indicators used in individual Member States. In the next step, the Commission will develop composite indicators for monitoring the condition and trends in all dimensions.
[32] For education, it is quite simple to measure output (e.g. by assessments within the Programme for International Student Assessment (PISA)), but more difficult to measure outcomes (e.g. employability). An example of an incomplete indicator is life expectancy, which does not include quality of life.
[33] The last year for which comparable data for the EU are available.

environment: personal income tax and corporate income tax were adjusted, civil taxes and real estate sale tax were regulated anew and the Value Added Tax Act was amended. The regulation of excise duties changed as well: the reduction of excise duties on petroleum products buffered the impact of rising oil prices on domestic inflation, and increasing excise duties on cigarettes finally adjusted their level to the European directive. Excise duties on electricity and a new tonnage tax were also introduced.

The reform of corporate income tax reduced the general tax rate, at the same time tightening tax relief. In addition to amended regulations to determine the tax base, a gradual reduction in the general tax rate was adopted (from 25% in 2006 to 23% in 2007, and then decreasing by one percentage point each year, until reaching 20% in 2010), and the 20-percent relief on investment in equipment and intangible long-term assets was abolished.[34]

The increase in the effective rate of corporate income tax shows an increase of this tax burden in 2007. Based on the Tax Administration Office's preliminary assessment[35] for 2007, the effective corporate income tax rate increased by 0.4% p.p. with regard to the previous year, totalling 19.2%. In conditions of good business results, this is, at a 2 p.p. lower normative tax rate, mainly a consequence of abolishing tax relief on investment. Due to the higher effective tax rate, the share of the corporate income tax in GDP increased to 3.3% of GDP (see Section 2.1.).

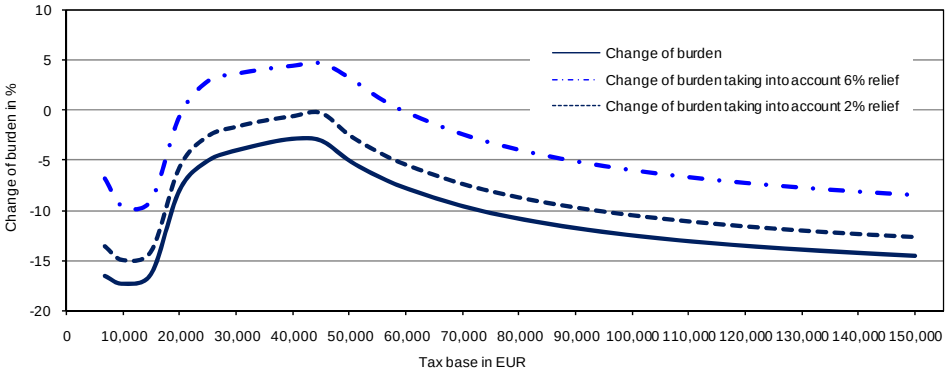
With the modification of burdens for taxable persons, the tax reform resulted in reduced budget revenue from this tax. The new Personal Income Tax Act implemented, with the existing definition of the tax base, a three-level tax scale (16%, 27% and 41%)[36] and simplified the tax relief system. Relief for various expenditures (up to 2% of the tax base) and tax relief for the purchase of a dwelling (up to 4% of the tax base) were abolished, while slightly higher general relief for all taxable persons was introduced; all relief linked to the status or activity of a taxable person was retained.[37] Last year, the average annual personal income tax burden on wages fell from 14.1% to 12.95% compared to the year before. This contributed considerably to the almost 3% decline in real terms in revenue from personal income tax. Consequently, its share declined to 5.4% of GDP compared to 2006 (see Section 2.1.).

As a result of the amended tax scale, the majority of taxable persons were disburdened, mostly in the lowest and highest income brackets. The highest reduction (20.1%) occurred in the lowest income bracket, with the annual tax base at EUR 13,600. At the limit where the tax rate increases, the reduced burden is less obvious. The smallest difference between the new and old systems (only 2.5%) is for the bracket at the EUR 44,000 tax base. Above this amount, the effect of disburdening strengthens again with the growing tax base. The reduction is

[34] The law permits only 20-percent relief on investment in internal research and development activities, and for the purchase of R&D services, relief for the employment of disabled persons, and for performing practical work in professional education, relief for voluntary supplementary pension insurance and for donations, and additional relief for less developed areas.
[35] The assessment already includes anticipated payments of final tax assessments in the current year.
[36] The new tax scale has two fewer classes: the highest tax rate was abolished (50%); two medium bands (33%, 37%) were merged into one with a lower rate than before (27%), while the low rate remained unchanged (16%).
[37] Relief for dependent family members has not changed much; disabled relief and senior relief for persons aged over 65 were retained; also relief for self-employed professionals in culture, journalists, student work and voluntary supplementary pension insurance remain valid.

actually lower because the new tax system abolished special relief for various expenses (2% of the tax base) and for the purchase of a dwelling (4% of the tax base). For a tax base between EUR 21,000 and EUR 60,000, taxable persons may actually be liable to pay more, on the assumption that taxable persons prior to the modification of the system exercised the right to one or both forms of relief (see Figure 14).

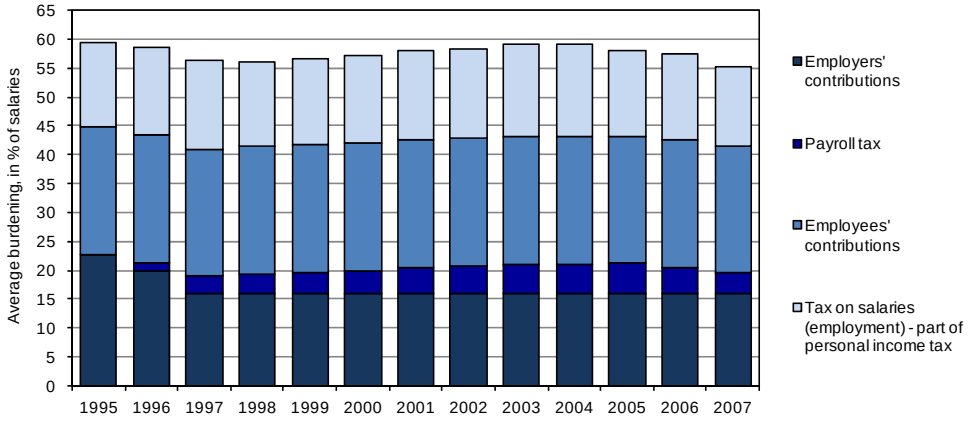
Figure 14: **Impact of the modified tax scale on burdening of the tax base**



Source: calculations by IMAD
Note: The tax base is the base on which personal income tax as per the valid tax scale is calculated. Tax relief represents a share of the tax base. The calculation takes into account the possibility of exercising special relief for various expenses in the amount of 2%, as well as an additional 4% for the purchase of a residence (up to 6% of the base).

In 2007, disburdening of salaries continued by reducing the payroll tax rate in the process of its gradual abolishment. Payroll tax was introduced in the second half of 1996 as an industrial policy measure to provide a source for financing the deficit which had occurred in the pension fund as a result of a reduction in social security contributions on the lowest wages. The rate of the employer's contribution to pension and disability insurance was reduced by 4 p.p. (from 12.85% to 8.85% of salaries), which should especially help labour-intensive industries such as timber, textiles, leather and construction. The lower limit of wages exempt from payroll tax was specified; otherwise, tax was paid on a progressive scale. The average payroll tax burden has grown over the years, from 3% of wages at the introduction of the tax to 5.1% in 2005, when the decision to abolish it by 2009 was taken. The gradual reduction in the payroll tax rate for the respective tax brackets (from 3.8%, 7.8% and 14.8% in 2005 to 3.0%, 6.3 % and 11.8% in 2006, and then 2.3%, 4.7% and 8.9% in 2007) reduced the average burden on gross wages from this tax. In 2007, it was 0.85 p.p. lower than the year before at 3.4%, which resulted in an almost 16% decrease in real terms in the revenue from this tax, and its share in GDP declined to 1.2% (see Section 2.1.).

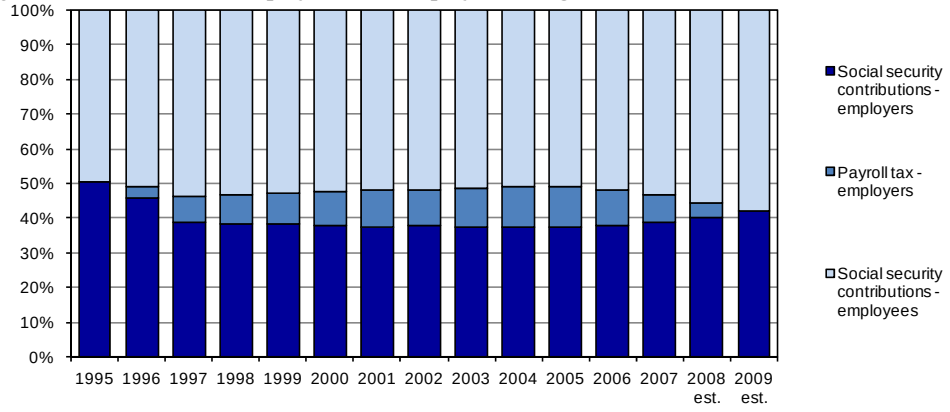
Figure 15: **Average burdening of labour with taxes and contributions in % of wages**



Source: PPA, Report on allocated general government revenues and cover (B-2), calculations by IMAD

The gradual abolition of the payroll tax reduces the tax burden on wages and changes the ratio of payments between employees and employers. Due to the gradual abolition of the payroll tax and the amended tax legislation, with unchanged rates of contributions for social security (38.2% of wages), the total burden of contributions and taxes on wages has been progressively declining in recent years. From 58.1% of wages in 2005, it fell to 57.4% in 2006 and to 55.2% in 2007 (see Figure 15). The abolition of the payroll tax is changing the ratio between contributions of employees and contributions of employers to cover obligations for social security. In 2007, the ratio between employees' payments and contributions and taxes paid by employers was 53:47. It is estimated that the abolition of the tax in 2009 will push up the share of payments of employees to 58:42 (see Figure 16).

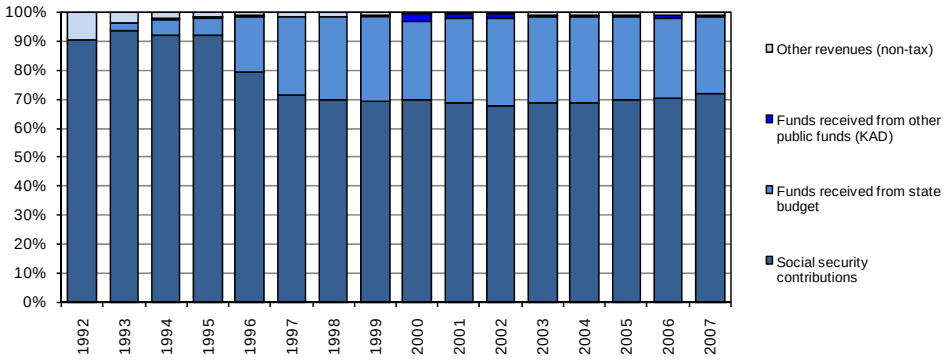
Figure 16: **Ratio between employees' and employers' obligations**



Source: PPA, Report on allocated general government revenues and cover (B-2), calculations and estimates by IMAD

The gradual abolition of the payroll tax results in a reduction of budgetary resources. After the reduction in contributions for pension and disability insurance, a transfer from the state budget ensured slightly above 28% of the annual revenues of the Pension and Disability Insurance Fund (ZPIZ). The transfer was highest in 2002, when it reached a 4.1% share of GDP; afterwards, it slowly fell, and in 2007, when in conditions of higher employment and higher inflation the contributions for social security were above expectations, it amounted to 3.2% of GDP.[38] The role of the payroll tax, which was formally an integral resource of the state budget, was to cover obligations from the ZPIZ social insurance. Between 2000 and 2005 its share was 41–48% of the total annual transfer from the state budget to ZPIZ. The gradual abolition of the tax is reducing the transfer coverage from this resource; in 2007 it represented only 37%, and when it is abolished in 2009, the financing of the transfer to the pension fund will put more pressure on other budget resources.

Figure 17: **Revenue structure of the Pension and Disability Insurance Fund (ZPIZ)**



Source: MF, Bulletin of Public Finance, calculations by IMAD

As tax resources decline and obligations grow, a restructuring of the state budget will be required both on the revenue and on the expenditure side. Transfer to the pension fund represents around 14% of total budget expenditure. ZPIZ expenditure is expected to grow because of population ageing, which will result in a relative increase in transfers to the pension fund in the coming years. Restructuring of budget expenditure or the introduction of new resources will be required.

The reform of certain income taxes performed last year had a positive impact on government revenues. Citizens' taxes were regulated anew in separate legal acts. Pursuant to the new *Inheritance and Gift Taxation Act,* regarding immovable and movable property, and also other real property and personal property rights, the number of taxable persons increased. According to the Act, the first order of succession is still exempt from tax, while the tax rates for the next orders of succession are slightly higher. The newly regulated tax base for real estate is

[38] Transfer to the pension fund (ZPIZ) has two purposes: 1) payment of government obligations which are not part of social insurance – ZPIZ has the role of the government's agent for payments, and 2) covering some ZPIZ obligations from social insurance which are not covered with contributions for pension and disability insurance. In 2007, EUR 384m were transferred from the state budget to cover the difference between resources and obligations, which represented around 10% of obligations from pension and disability insurance.

established at 80% of generalised market value on the basis of a regulation on comprehensive revaluation. The *Act on the Taxation of Water Vessels* expands the base of taxable persons,[39] including non-residents if they are registered in the Slovenian shipping register, whereby vessels used for performing registered gainful activity are exempt from taxation. Also, the *Real Estate Sales Tax Act* was amended and specifies in more detail and expands the scope of taxation, whereby the tax base is linked to the generalised value of real estate established in compliance with the *Real Property Mass-Appraisal Act*, and the tax rate remains at 2%. The Act specifies exemptions from tax, while up to now only legal practice was considered. The aforementioned reforms of income taxes had a positive financial impact; in 2007 revenues from tax on real estate sales increased in real terms by around 32%.

3.3. Efficiency of government expenditure

A multi-annual programme approach to planning the use of budgetary funds was introduced in order to improve the efficiency of government spending. Several years ago, Slovenia started introducing modern budgetary procedures and a results-oriented budget. This was aimed at enabling the monitoring of the efficient use of funds, and by ensuring higher flexibility of government expenditures[40] while also improving their composition. A centralised system of public procurement was introduced which would ensure better control over the use of budgetary funds. The Private-Public Partnership Act was passed last year to stimulate investment projects.

A system to measure the efficiency of government expenditure is being developed. The process of selecting useful and reliable indicators which will adequately monitor the achievement of objectives[41] is being hindered by the fact that internationally comparable criteria to assess efficiency are not yet agreed, and in some fields, comparable databases are not available. The statistics on government expenditure based on the classification of functions of government, which only at the second level (COFOG II)[42] enables efficiency assessment, should be completely set up next year. Unified records of development policies per individual programme, project and measure are being prepared,[43] which will enable the assessment of the quality of public finance at programme level. Efficiency indicators for government development policies will probably be available this autumn, and efficiency indicators for development programmes, which will measure quality with regard to *input*, *output* and *outcome*, at the beginning of 2009.

Based on the existing methodological framework, the first assessments of the efficiency of government expenditure and other instruments of fiscal policy were performed. With regard to methodology and conceptual limitations in

[39] The tax includes vessels 5 m in length (previously, 8 m), whereby the amount of tax is determined with regard to the length and power of the vessel.
[40] Slovenia, with its 72% of fixed expenditure (social transfers, interest, wages and subsidies), is above the average of the new EU Member States, which amounts to 68% (IMF, 2006).
[41] Indicators to measure long-term objectives are specified only for 31% of state budget expenditures, of which half do not have a target value. 61% of state budget expenditures have indicators defined to measure annual objectives (Derenčin, 2006).
[42] Eurostat implemented statistical methodology at the level COFOG II to be used for monitorining government expenditure, where, despite constant progress, considerable limitations in availability of data for all Member States still exist.
[43] Decree on development planning.

monitoring individual spheres of government expenditure, especially in the longer term, we present only the results of the most recent efficiency assessments for two groups of expenditure: social expenditures, which were the central topic of economic policy discussions within the Slovenian Presidency of the EU, and state aid, the efficiency of which was measured in the light of its influence on competitiveness this year for the first time.

3.3.1. Efficiency of social expenditure

The priority of most EU Member States is to increase the efficiency and effectiveness of social expenditure. Social expenditure[44] is one of the major items within total government expenditure, both in Slovenia and the EU Member States; in the EU-25 it amounts to an average of as much as 54% of government expenditure, or 27.2% of GDP. The increased efficiency and effectiveness of this expenditure is one of those priorities which are common to most Member States. Because the system of social expenditure is, in addition to the tax system and relief, also part of the system of social redistribution which countries use to alleviate poverty and reduce income inequality, monitoring the trends of this expenditure at the same time represents an assessment of the efficiency of social policy of a certain country. Increased efficiency and effectiveness of social expenditure is therefore important both in the light of ensuring the efficiency of public spending, as well as in the light of the effectiveness of social policy within the context of implementing the Lisbon Strategy. EU countries, including Slovenia, are making many changes aimed at modernising the system and increasing efficiency (see Section 2.2.4. in the chapter "Challenges of the Labour Market from the Aspect of Flexicurity"). In doing so, they need to comply with the principle that reform in one sphere of social expenditure should not neutralise reform in another sphere. Modifications of the complete system of social expenditure, which comprises the system of social protection and the tax system, including tax relief, should be planned in such a manner that partial reforms in various fields act coherently.[45]

Indicators and appropriate methodologies to measure the efficiency and effectiveness of social expenditure at EU level are in preparation. The European Commission uses selected indicators for this purpose: 1) share of social protection expenditure in GDP; 2) at-risk-of-poverty rate before and after social transfers; 3) reducing income inequality (quintile coefficient, Gini coefficient); 4) share of administrative costs in implementing social protection programmes; and 5) marginal effective tax rates.

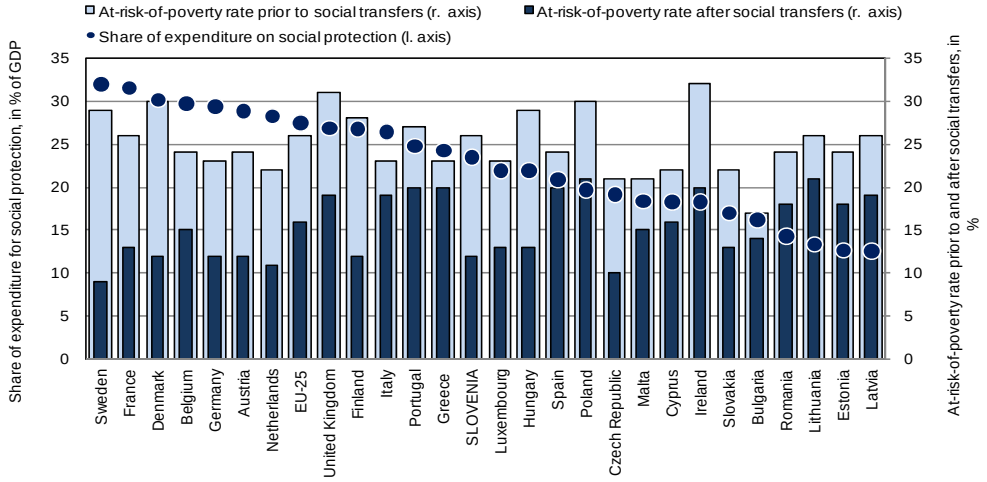
The basic indicator of social protection – the share of expenditure for social protection in GDP – shows that Slovenia allocates relatively less funding for social protection than the average in the EU. The share of social protection expenditure in GPD,[46] which varies considerably between EU Member States, depends on tradition and differences in social models, the demographic situation

[44] Social protection expenditures as defined by the European Commission on the basis of ESSPROS are as follows: old age and survivors, sickness and disability, children and family, unemployed, housing and social exclusion (Efficiency and effectivnes of social spending, Brussels, Achivements and Challenges, 11 March 2008).
[45] Ecofin conclusions being prepared by the Presidency for the May Ecofin meeting; Annex II, Brussels, 2 April 2008.
[46] European System of Integrated Social Protection Statistics – ESSPROS.

of the country and its level of economic development. In 2005, Slovenia allocated a smaller share of GDP for social protection compared to the EU average: 23.4% compared to 27.2% in the EU-27.

Without social transfers, the at-risk-of-poverty rate would double in Slovenia, which indicates the extremely high impact of social expenditure on alleviating poverty. Although the share of social protection expenditure in GDP has slightly declined in recent years, the poverty risk in the same period did not increase, but remained at approximately the same level. Data on the at-risk-of-poverty rate before and after social transfers show the considerable impact of social transfers on alleviating poverty, given that the at-risk-of-poverty rate would double without them (see Table 7).[47] The impact of social transfers on alleviating poverty in Slovenia is greater than the average in EU countries (in Slovenia there has been a reduction from 24% to 12%, in the EU-25 from 26% to 16%).[48] Our assessment is that this is to a large extent the consequence of a selective approach to entitlement to certain social rights, which means that the beneficiaries to a greater extent come from lower income groups (in some EU countries a system of universality is in place for certain social rights).

Figure 18: **Share of expenditure on social protection and the at-risk-of-poverty rate in the EU**



Source: Development Report 2008

According to the latest data, Slovenia had the lowest income inequality among EU Member States. In 2005, Slovenia recorded the lowest income inequality, alongside Denmark, measured by the ratio of quintile classes. In addition, income inequality measured using the Gini coefficient was among the lowest at that time in the EU-25, at 24% (see Table 7).

[47] A number of empirical studies have confirmed the correlation between the extent of social spending and the alleviation of poverty and social exclusion whereby the impact is greater on the reduction of poverty level than on the reduction in at-risk-of-poverty rate. The differences between countries are considerable. Countries with similar levels of social spending achieve different levels of poverty reduction due to distinct socio-economic situations, social policy, etc.

[48] The International Monetary Fund in a survey (IMF, 2006) establishes that, in a sample of 26 countries, Slovenia ranked 19th by the efficiency and effectiveness of expenditure on social protection.

Administrative costs of managing social expenditure were lower than the EU average. Administrative costs for the implementation and distribution of social protection programmes in 2005 amounted to 2.0% of total expenditure on social protection and were 1.1 p.p. lower than the EU average (see Table 7).

Labour incentives increased in 2007. This is confirmed by the reduction of effective marginal tax rates (see Table 7), which are used to measure the combined impact of taxes and social transfers on net income in the transition from unemployment to employment, or from a lower-paid to a better paid job.[49] These rates also indicate individual decisions on employment, or a better paid job. Comparison with the EU shows that Slovenia is lagging behind the EU in these indicators, except in the sphere of tax burdens, where it is close to the EU (see also Section 2.2.4. in the chapter "Challenges of the Labour Market from the Aspect of Flexicurity").

Table 7: **Efficiency indicators for social expenditure in Slovenia and the EU, 2004–2007**

	Slovenia				EU-25			
	2004	**2005**	**2006**	**2007**	**2004[6]**	**2005**	**2006**	**2007**
Share of social protection expenditure in GDP	23.7	23.4	N/A	N/A	27.3	27.2[1]	N/A	N/A
The at-risk-of-poverty rate before social transfers (pensions excluded from income; income in kind is not considered); in %	N/A	25.8 (IS)	24.2	N/A	26	26	26	N/A
The at-risk-of-poverty rate after social transfers (pensions excluded from income; income in kind is not considered); in %	N/A	12.1 (IS)	11.7	N/A	16	16	16	N/A
Quintile coefficient 80/20	N/A	3.4 (IS)	3.4	N/A	4.8	4.9	4.8	N/A
Gini coefficient (%)	N/A	24 (IS)	24	N/A	30	30	30	N/A
Share of administrative costs in total expenditure on social protection	2.0	2.0	N/A	N/A	3.1	3.1	N/A	N/A
Tax burden on labour costs[2]	43.2	41.6	41.2	40.7	39.8[1]	39.7[1]	40.1[1]	N/A
Unemployment trap[3]	87.7	82.6	82.2	80.7	74.11[1]	75.04[1]	75.39[1]	N/A
Low wages trap for a single person without children[4]	49.1	50.8	51.6	51.0	46.70[1]	46.71[1]	47.35[1]	N/A
Low wages trap for a couple with two children[5]	91.9	76.4	72.6	67.4	58.84[1]	61.57[1]	62.19[1]	N/A

Source: Eurostat EU Portal; Eurostat Data Navigation Three; SORS, Indicators of labour incentives, Slovenia, 2007 – PROVISIONAL DATA; 14 May 2008, Initial disclosure

Notes:
[1] Data for EU-27.
[2] The tax burden on labour costs shows the overall inpact of taxes and contributions for social security and social transfers on labour costs, whereby the calculation assumes a single person without children, receiving 67% of the gross wage of an average employed person.
[3] The unemployment trap is the ratio between the net and gross income of a single person without children in transition from unemployment to employment, where it is considered that an unemployed person receives unemployment benefits in the amount of 70% of the gross wage of an employed person, who receives 67% of the gross wage of an average employed person.
[4] The trap of low wages for a single person is the ratio between net and gross income of an employed single person in transition to a better paid job (from 33% of the gross wage of an average employed person to 67% of the gross wage of an average employed person).
[5] The trap of low wages for a four-person household with one employed person and two children shows the ratio between the net and gross income of an employed person in transition to a better job (from 33% of the gross wage of an average employed person to 67% of the gross wage of an average employed person).
[6] The data are not completely comparable to data for Slovenia, because Eurostat has not yet included the new SORS calculations.
N/A – data not available, IS – interrupted series

[49] Effective marginal tax rates measure: tax burden on labour costs, unemployment trap and low wages trap.

3.3.2. State Aid Efficiency

Subsidies and state aid are fiscal instruments used in industrial policy which bolster economic competitiveness and changes in market structure. Since their influences may also be negative, it is wise to use them only if they were studied accordingly in several respects, mostly from the point of view of their impact on competitiveness,[50] international trade and government expenditure (as well as cost).

Efficient state aid is aid which is oriented to small and medium-size enterprises, R&D and stimulating employment. Aid to small and medium-size enterprises has proved to be one of the most efficient purposes of state aid, because it helps increase employment, and boost sales and productivity in enterprises, i.e. aid beneficiaries. The same could be said for efficiency based on return on assets. As distinguished from most other aid purposes, it is efficient in ensuring sustained annual and cumulative improvements in enterprise operations after several years. Analyses have shown that aid is most efficient in the most technology-intensive sectors and in enterpirses with a relatively high level of sales per employee, as well as in enterprises employing only a few employees. State aid granted for research and development (R&D) has had a positive, although short-term effect on the volume of available resources to be used for research and development. In contrast to their competition not receiving aid, enterprises that are beneficiaries of aid increased the volume of expenditure in research and development (R&D). On average, larger enterprises (based on total sales) make better use of the allocated aid because the "additionality" effect of state aid can be seen (in case of exclusion from the programme, the aid beneficiary would reduce the total level of expenditure for R&D). There is a greater probability of the substitution effect with small beneficiaries of aid (the aid beneficiary would in the case of exclusion from the programme nonetheless carry out its R&D projects). Multiple consecutive receipts of aid negatively influence increases in the enterprises's own expenditure on R&D. Obviously, enterprises start to behave rationally, making use of public resources from aid programmes instead of using their own assets. Aid used for stimulating employment proved to be a success in increasing employment (in the years following the receipt of aid and also cumulatively until the end of the period of three years), as compared with the year prior to the allocation of aid. The same holds for the efficiency of aid with respect to the allocated funds, where it is required to assess whether the number of additional employees (1.7 to 1.9) per every EUR 4,172 of aid is adequate to justify its volume. The efficiency of aid declines tremendously by each additional amount of aid provided to the same enterprise. On average, aid is more efficient in enterprises with a larger sales volume.

Aid used for training and achieving regional objectives is not efficient enough. Allocating *training aid* has successfully influenced the increase of average wages in beneficiary enterprises. It did not increase sharply, since in four years it has amounted to between 8 and 16% of average gross salary from 2003. Less convincing is the evidence on the impact of aid on productivity in beneficiary

[50] The first research in Slovenia (Target Research Programme "Competitiveness of Slovenia 2006−2013", project No V5-0201) was conducted from the point of view of the impact on the economy's competitiveness using the econometric matching method, with which allocated state aid in the period from 1998−2006 was analysed according to individual categories and purposes, recipients and aid intensity, as well as single or multiple allocations to the same beneficiary.

enterprises. Assessments of aid efficiency in other countries are essentially more favourable than in Slovenia.The reasons for this most likely can be traced to the amount of aid per beneficiary (average amounts in Slovenia are quite small), and programmes to which the aid is allocated. *Regional state aid* on average positively impacts sales, employment and added value per employee only in the first two years after the aid is received. According to a somewhat more favourable result in analysing the efficiency of allocated funds, it can be assumed that otherwise this type of aid can be successful in improving efficiency and increasing employment, as well as in boosting sales, but the funds have been distributed inadequately among aid beneficiaries. Here it can also be observed that aid is much more efficient in technology-intensive sectors and that the effect dwindles with the succesive granting of aid.

Aid intended for rescuing and restructuring enterprises is inefficient, as well as aid allocated to special sectors (coal mining, energetics, transport). State aid for rescuing and restructuring has proved inefficient in boosting sales, creating new jobs and increasing productivity in beneficiary enterprises. Aid beneficiaries are mostly in sectors which are threatened most because of globalisation pressures, and it is unrealistic to expect to save them from decline. Similarly inefficient is state aid granted according to special sectoral rules. Trends in employment, sales and productivity were no different in enterprises granted aid from similar companies that had not received aid.

Planning state aid according to specific purposes insufficiently addresses the goal of efficiency. Among the *most efficient*, aid for small and medium-size enterprises increased only in 2006 (aid was minimal particularly in the period between 2002−2005). Aid granted for R&D has been decreasing since 2003. In 2006 the positive trend reversed and the share of aid to companies decreased and at the same time the share of aid increased in less efficient research and higher education institutions. Aid stimulating employment has been gradually increasing since 2004 but is still only half the amount of that in 2000−2002. Among *less efficient* examples, aid for training is particularly low, while regional aid, on the other hand, increased significantly in 2005 and 2006 but is still somewhat lower than the average in the EU Member States. Among the *inefficient* examples, aid granted for rescuing and restructuring was abundant in the periods 1998–2001 and 2003–2004 and then stopped in 2005, but it was granted again the following year. Aid granted by special sectoral rules dropped increasingly in the last two years but is still high, mainly due to high levels of aid granted to railways.

Distributing available state aid to individual beneficiaries is still primarily oriented to "rescuing" bad companies. Most aid in manufacturing is directed towards lower and mid-lower technology-intensive business, not only for rescuing and restructuring them but also for other purposes. This indicates that it is not directed to the required structural changes aiming at higher technological intensiveness and thereby strengthening the competitiveness of the Slovenian economy, but rather to solving the problems of existing, less competitive enterprises.

Table 8: **State aid distribution by size (in deciles), in 2006**

Business	Distributed/received amounts of state aid (in deciles)								
(deciles)	R&D	Environment	Energy Saving	R&R	SMEs	Employment	Training	Regional objectives	Agriculture
1	1.00	1.00	1.00		1.00	1.00	1.00	1.00	1.00
0.9	0.38	0.31	0.54		0.16	0.50	0.57	0.24	0.05
0.8	0.25	0.10	0.39		0.04	0.39	0.41	0.11	0.03
0.7	0.18	0.07	0.29		0.03	0.33	0.29	0.05	0.02
0.6	0.12	0.05	0.20		0.02	0.27	0.20	0.03	0.01
0.5	0.08	0.02	0.12		0.01	0.22	0.13	0.02	0.01
0.4	0.05	0.01	0.06		0.01	0.16	0.08	0.01	0.00
0.3	0.03	0.00	0.03		0.00	0.11	0.05	0.01	0.00
0.2	0.01	0.00	0.01		0.00	0.07	0.02	0.00	0.00
0.1	0.00	0.00	0.01		0.00	0.03	0.01	0.00	0.00
In EUR thousands	19,473	2,568	623	2,141	29,270	16,904	1,844	45,897	51,951
Number of companies	245	26	41	6	1,634	4,567	350	115	3,572

Sources of data: Target Research Programme "Competitiveness of Slovenia" 2006−2013, project No V5-0201
Note:
R&D = research and development, R&R = rescuing and restructuring, SMEs = small and medium-size enterprises. For saving and restructuring the distribution can not be shown in deciles because there are too few aid beneficiaries.
The first section of the table displays beneficiaries and amounts of aid in deciles; the second section shows the actual number of beneficiaries in the business register, as well as the amount of aid received. Aid beneficiaries are distributed using tenths of value (that is, in deciles) according to the amount of state aid received. Thus, for example, 90% of beneficiaries of aid granted for R&D (distributed in 0.9 deciles) equivalent to 220 beneficiaries receiving 38% (0.38 deciles) of total aid for this purpose, i.e. EUR 7,400 thousand. The 10% of beneficiaries that received the highest amounts of aid are distributed in the above category (1.00–0.9 deciles). These beneficiaries (25) received 62% (1.00–0.38 deciles) of total aid granted for R&D, i.e. EUR 12,073 thousand.

State aid in Slovenia poses a potential threat to market competition and is above average from the point of view of expenditure and cost. The research did not return any explicit assessment for either parameter used for measuring state aid efficiency, but they can be assumed from their concentration (see Table 8).[51] On the one hand, 10% of beneficiaries receive from 43% (training) to 95% (agriculture) of total aid. Some receive this from more than one source. Beneficiaries of large amounts of aid are mainly larger enterprises, which can potentially influence competition in their sector. On the other hand, over half of the beneficiaries receive too little aid to alter their behaviour, which is the fundamental condition of aid efficiency. Thus, the expenditure and costs for the country (costs of taxes to finance state aid, administrative and transaction costs) are greater than the benefits for the beneficiary.

[51] Even greater concentration is shown by subsidies from annual accounts. The top 10% of subsidy recipients are granted from 91−93% of all subsidies annually. A more detailed analysis of market power, measured using the method of the recipient's market share of 40% and CR-4 (top four recipients with a total of 40% of market share) has shown that market competition is threatened in numerous sectors (Murn, 2008: 90−92).

4. Key findings and recommendations

With favourable economic conditions in 2007, the fiscal position in most EU Member States improved considerably, the most in recent years. The government deficit reached an all-time low in the Eurozone (0.6% of GDP) as well as across the entire area of the EU (0.9% of GDP). Because of the improved fiscal position and favourable economic trends, total government debt also reached an all-time low. It reached 58.7% of GDP, and was lower than the reference value. In the Eurozone it still remained 6.0 percentage points above margin, despite its decline.

Last year Slovenia featured lower government expenditure, a lower deficit and subsequently lower debt. The deficit of the general government sector has been decreasing compared with gross domestic product in recent years, and in 2007 declined to 0.1% of GDP. Relative to the previous year, the deficit was lower by 1.1 percentage points because general government revenue increased more compared to expenditure, and growth in both categories lagged behind the growth in gross domestic product. Favourable fiscal movements as well as the early repayment of debt and active debt management contributed to lowering consolidated general government debt, which at the end of last year amounted to 24.1% of GDP.

The trend in the cyclically adjusted general government balance shows, besides a favourable macro-economic situation, that fiscal policy measures contributed to fiscal consolidation. Last year, the cyclically adjusted deficit decreased along with the actual deficit, which is in accordance with Stability and Growth Pact provisions and indicates restrictive fiscal policy. Considering the closure of the output gap, this means that fiscal policy last year, for the first time in the observed period, was counter-cyclical and restrictive, which implied a proper response of fiscal policy in respect to its stabilising role in the first year after entering the EMU.

Last year showed favourable movements, but the long-term challenge for fiscal policy to adjust to expected demographic changes still remains. Eurostat's population projections show that the share of the population over 65 will increase rapidly by 2050, while the share of the working age population aged 15 to 64 will decrease. Slovenia is among the more exposed EU countries in ensuring long-term public finance sustainability due to extremely high growth in expenditure related to ageing. If the system parameters and economic policies remain unchanged, in the decades to come they will contribute to increasing deficits and therefore general government debt.

After a substantial decrease in the share of public spending in GDP over the last four years, increasing efficiency and effectiveness is becoming a more and more important aspect of expenditure reform. Several years ago Slovenia started to implement modern budgetary procedures, which should improve the monitoring of efficiency and effectiveness of the use of resources. Sufficient data is not available to run a complete analysis, but assessments were made on the efficiency and effectivness of social expenditure and state aid. Considering the EU average, Slovenia has a lower at-risk-of-poverty rate and income inequality, despite lower expenditure for social protection. Different effects are achieved with state aid, depending on the purpose of its allocation. Assessments show that the efficiency

objective is not pursued enough in the allocation of aid. A comprehensive analysis of the quality of public finance will be possible following the establishment of a conceptual framework, according to the European Commission's proposal. While methodological and statistical restrictions in monitoring individual fields still exist, it is primordial to improve the systems of measurement.

To ensure good quality of public finance it is important to implement structural reforms. Besides the relative size of fiscal aggregates, the efficiency and effectiveness of government revenues and expenditure is of key importance for the quality of public finance. In the field of government revenue, where in respect of its effects on economic activity efficiency is to a great extent determined by the tax burden on labour and capital, tax reform was adopted in 2007. Due to changes in personal income tax legislation and the gradual abolishment of the payroll tax, the burdening of wages with taxes and contributions declined. The gradual abolishment of the payroll tax contributed to the disburdening of the economy, while the increase in the effective tax rate, following corporate income tax reform, increased the burden.

Appendix

Approaches to the calculation of a Medium-term Objective (MTO)

Approach A is based on a frontloading adjustment to the medium-term objective (hereinafter: MTO). The MTO is equivalent to the required structural balance (RB) for achieving sustainability, i.e. primary structural balance (PB) added the sustainability indicator S2. In accordance with such an approach, the MTO is calculated using the following formula:

$$MTO = RB = S2 + PB - i*D$$

where the sustainability indicator of the public financing gap is represented by S2, primary structural balance by PB and interest payments by i*D.

Approach B is based on the principle of gradual adjustment, where the MTO is determined as the sum of an accordingly selected reference point (RP) and set share of the difference between the required balance and the aforementioned reference point value. The share of the difference represents the volume of adjustment made in the first years of the adjustment period. In accordance with this approach, the MTO is calculated using the following formula:

$$MTO(\alpha) = RP + \alpha (RB-RP) = (1- \alpha)RP + \alpha RB$$

where the reference point of fiscal balance is represented by RP, RB represents the required balance for achieving and maintaining fiscal sustainability, and α the share used in measuring the volume of adjustment in the first years. Determining the budgetary reference point follows the existing principle used in calculating the medium-term objective. Using such a method allows sufficient consideration of the different fiscal positions in the Member States. Because of its simplicity and rationality, the following rules are currently used for determining the reference point:

- for countries with a deficit between -1 to -0.5% of GDP, the reference point amounts to -0.5% of GDP
- for countries with a deficit between -0.5% to 0% of GDP, the reference point amounts to 0% of GDP
- for countries which are close to balance or in surplus, the reference point amounts to +0.5% of GDP.

The parameter value used for Slovenia was $\alpha = 0.5$, which means that fiscal policy must enable half of the ageing-related expenditure to be covered.

Approach C is based on the assumption that the process of public finance adjustments in an individual Member State crucially depends on its specific economic situation. In accordance with this assumption, the formula used in calculating the MTO enables better inclusion of the specific concerns of individual countries:

$$MTO = RP + SM$$
$$MTO = RP + \alpha((RB+LTF)-RP)$$

where RP represents the reference point, RB the required balance, LTF additional long-term factors, and α the share used in measuring the volume of adjustment in the first year. Such an analytical framework allows for other sustainability factors to be considered when assessing fiscal position and not only outstanding government debt.

The proposed approach puts greater stress on the existing debt and fiscal position. All three approaches are flawed by disregarding outstanding debt, putting countries with lower levels of outstanding debt such as Slovenia in an unequal position in comparison to countries whose outstanding debt levels are higher. This flaw could be removed by adjustments to the formula. According to one of the informal European Commission's proposals, we could add the expression $\beta(D_t - 60)$ to one of the above-mentioned rules, where D_t would represent the share of debt in the current year's GDP, and β a value parameter between 0 and 1 ($1 > \beta > 0$), further representing the share of the difference between outstanding debt and the allowed upper debt margin (60% of GDP). Here the difference depends on the fiscal policies pursued by the various countries. Including a new expression in the formula would mean that countries with a high-level indebtedness should have a higher medium-term objective than envisaged using approaches A, B or C. On the other hand, countries with a low-level of indebtedness may have a lower MTO than any envisaged using the above-mentioned approaches.

In accordance with the above guidelines, the new medium-term objective could be determined using the following formula:

$$MTO=((r-g)/g)(0.03-m)$$

where the average effective interest rate of government debt is represented by r, the average nominal trend economic growth is represented by g, and the safety margin by m.

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