SUMMARY

Last year, the public finance deficit in the EU as a whole narrowed for the first time since the beginning of the crisis and debt growth eased. In most EU countries fiscal consolidation measures were focused on reducing expenditure, primarily by streamlining public sector operations, restricting hiring and intervening in wages and social transfers. In some countries, short-term measures were complemented with systemic changes geared towards long-term sustainability of public finances, particularly in the area of pensions. On the revenue side, several countries introduced changes to tax legislation, i.e. towards additional taxation of consumption and wealth and changes aimed at relieving the tax burden on the economy. After a significant acceleration in 2009, the growth of the general government debt in the EU and euro area as a whole slowed somewhat in 2010 and 2011, but was still much higher than before the crisis. In the whole period, the increased borrowing was, besides high primary deficits and growing expenditure on debt servicing, significantly affected by the financing of a number of anti-crisis measures that were focussed primarily on ensuring the stability of the financial system, in particular the increase of capital of financial entities.

Government bond yields in the most exposed euro area countries are still high and financial market conditions remain uncertain. Uncertainties about the resolution of the sovereign debt crisis in the euro area are reflected in higher costs of borrowing for almost all euro area countries, especially the most indebted, i.e. the most exposed, countries, including Slovenia. The yields, which declined temporarily mainly due to non-standard measures of the ECB, which alleviated liquidity problems of the euro area banking system by means of longer-term refinancing operations, have been growing again since April. Regardless of great consolidation efforts planned in a number of euro area countries for this year and 2013, distrust of financial markets remains high under the strong impact of economic and political conditions, particularly in the most heavily indebted countries.

At the EU level, legislative documents were adopted last year to reinforce coordination of fiscal policies. Next year the so-called fiscal pact should enter into force for euro area countries, introducing a balanced budget rule; furthermore, permanent financial stability mechanisms were created. The new legislative package aimed at strengthening economic governance and coordination of fiscal policies introduces stricter financial supervision in the EU and determines the procedure of sanctions. A further step towards a closer coordination of fiscal policies is the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (i.e. fiscal pact) signed in January 2012, which introduces a balanced budget rule and is binding on euro area countries. The treaty is foreseen to enter into effect on 1 January 2013 and the contracting countries will have to transpose the balanced budget rule into national legal systems, i.e. constitutional or equivalent legislative documents, at the latest one year after the treaty will enter into force. To ensure long-term stability of the euro area, the governments also agreed to create more permanent financial stability mechanisms. A permanent rescue fund named the European Stability Mechanism (ESM) will enter into force in July 2012, and its lending capacity, together with that of the temporary fund (ESFS), which will run in parallel until the middle of 2013, will total EUR 940 bn. Against the background of government efforts for deficit reduction and closer coordination of fiscal policies, calls for initiatives that would boost growth and employment in line with the already adopted Europe 2020 strategy have been gaining momentum at the level of the EU.

Unlike in most EU countries, the general government deficit in Slovenia grew somewhat in 2011 and reached the highest level since 1995. After remaining at a relatively high level (around 6% of GDP) in 2009 and 2010, the deficit grew somewhat again last year and totalled 6.4% of GDP. In 2011, the deficit thus exceeded by 0.9 p.p. the deficit envisaged in last year's Stability Programme. The principal reason for the increase in deficit and the divergence from the consolidation targets was expenditure relating to equity injections and the takeover of debts from certain public companies (in the amount of 1.3% of GDP). The increase in the debt-to-GDP ratio was also affected by a decline in economic activity. Excluding expenditure on capital transfers, other expenditures together were even lower than foreseen in nominal terms, owing to a

substantial decline in government investment and subsidies; expenditure on goods and services also shrank more than expected.

The general government debt is approaching 50% of GDP and is growing faster than the euro area average. The debt started to increase more rapidly in 2009, when it rose by as much as EUR 4.3 bn (or 13.4 p.p.) due to the borrowing related to deficit increase and due to the pre-financing of the borrowing requirement for 2010. In 2010 and 2011, the debt continued to grow. In 2011, the increase was also a result of the pre-financing of the borrowing requirement for 2012. At the end of 2011, Slovenia's general government debt was almost double the level in 2008. Although it is still much below the euro area average, it grew relatively faster in the past three years (by 25.7 p.p. of GDP; in the euro area by 20.0 p.p. of GDP), which is affecting the perception of Slovenia in international financial markets.

With modest consolidation efforts in previous years, achieving the fiscal goals will be even more challenging in the changed macroeconomic environment. Amid the tightened situation on financial markets, limited access of the government to sources of finance and the deteriorated conditions and prospects in the domestic environment and abroad, the pace of consolidation will have to be faster. Another important reason for the more rapid consolidation is the provisions of the new EU fiscal framework and stricter sanctions for Member States. Since there was no progress in fiscal consolidation in Slovenia in the past two years, a relatively greater fiscal effort is now needed to bring the deficit below 3% of GDP in 2013. Given the commitments under the excessive deficit procedure, this is also necessary to increase the credibility of the country and improve the perception of financial markets, which would help Slovenia lower the borrowing costs and keep them on a sustainable track.

The Stability Programme – 2012 Update (PS 2012) anticipates that the excessive deficit will be corrected in 2013, in line with the recommendations of the Council in the excessive deficit procedure. After the revision of the state budget and enforcement of the amendments to the Public Finance Balance Act (ZUJF),[1] which also refer to other general government budgets and extra-budgetary users, the general government deficit is set to decline by 2.9 p.p. this year and total 3.5% of GDP. This year's stability programme projects that the deficit will decline below 3% of GDP in 2013 (2.5% of GDP). The fiscal consolidation strategy primarily relies on cutting general government expenditure, but it also foresees measures to improve the efficiency of collection and the quality of general government revenue, and introduces tax incentives for R&D and investment to simulate economic activity. By implementing the measures, the government is thus, consistent with the Council recommendations, planning to correct the excessive deficit by the end of 2013, and reduce the deficit to 0.4% of GDP and restore the structural balance of public finances by the end of the programming period.

The Stability Programme 2012 sets more ambitious goals for deficit reduction. For the first time, expenditure will also decline in nominal terms. Moreover, the expected reduction is mainly based on the already adopted and negotiated measures, which have greater credibility. This is a positive step and a shift from the previous approach that relied only on interventions in the flexible part of the budget, which required practically no legislative changes. Expenditure reduction, now supported by legislative changes, is based on three sets of measures: (i) rationalising public sector operations; (ii) limiting investments, subsidies and programmes; and (iii) adjusting labour market and social security policies. The rationalisation of the public sector involves organisational changes and interventions in the area of wages and other labour costs and employment. Reforms and modernisation of individual policies are meant to gradually lower expenditure on labour market, health care and social security policies. The fiscal effort is higher than planned in the Stability Programme 2011, and this year and in 2013 expenditure is also expected to decline in nominal terms. Taking into account both the adopted and planned measures, the decline will be mainly due to lower compensation of employees and lower expenditure on goods and services and social transfers. This year's stability programme also envisages measures that will affect tax revenue in the programming period, i.e. raising taxes or introducing

[1] The Public Finance Balance Act, which intervenes in more than 39 sectoral laws, was adopted by the National Assembly on 12 May 2012.

new taxes, as well as measures to stimulate economic activity, such as lowering the corporate income tax burden and increasing tax relief for investment.

In the short-term, the adopted austerity measures are a crucial step in reducing the deficit below the upper ceiling of 3% of GDP. The adopted fiscal consolidation measures will make it possible for Slovenia to reach its commitments under the excessive deficit procedure and are therefore essential, although they are still mainly intervention measures in nature. Moreover, they do not always ensure equal conditions for all budget users, particularly as regards material costs and funds for investments. This means that they do not ensure a sustainable reduction of the public finance deficit, as they can lead to a deterioration of the quality of certain public services already in the medium term. The latter mainly holds true for measures in the areas of education, research and health care. Furthermore, employment policy measures are mainly focussed on restricting hiring, which can amid the anticipated pace of retiring and restrictive wage policy deteriorate the quality and efficiency of public services in the medium term. It should be noted that greater cuts will have a stronger negative impact on economic activity, particularly in the first years of the implementation of measures, which calls for a prudent combination of further economic policy measures. An increase or introduction of indirect taxes should also be considered in this context, as these taxes have relatively smaller adverse effects on economic growth. Besides by changing environmental taxes, general government revenue could also be increased by raising value added tax, a possibility which is otherwise foreseen in the ZUJF only for the case of a fiscal emergency. In this context, it is crucial to avoid a spillover of higher tax rates into the growth of wages and transfers through adjustment to inflation. The latter would lead to renewed growth in general government expenditure and would have a negative impact on the competitiveness and employment in the entire economy.

In the medium term, more far-reaching structural measures will be needed to achieve the sustainability of public finances. The solutions should involve a further rationalisation of public sector operations by structural measures for increasing efficiency and restructuring that will be geared towards the strengthening of the role of development expenditure in promoting competitiveness and ensuring long-term sustainability of social security systems. Another challenge is finding more permanent solutions in the area of recruitment in the public sector that would, by a combination of more accommodating employment and wage policies, create a stimulating environment for employees and improve their efficiency. The foreseen reduction of investments, with a risk of further cuts, will also weigh on the economic recovery. It is therefore crucial to ensure the anticipated co-financing from EU funds by high-quality projects, and to strengthen public-private partnership as envisaged. As regards subsidies, subsidies for private companies are declining in particular, although the continuing subsidies granted for financing certain public companies are more problematic from the perspective of development. In the future, the granting of subsidies should be to a greater extent supported by a comprehensive industrial policy and a system for monitoring and assessing their effects. However, the implementation of changes in social protection systems (in particular pension reform) remains of crucial importance for the sustainability of public finances already in the medium term. The Stability Programme envisages that these reforms will be put in place already by the end of 2013, which is essential for achieving the set goals.

Preserving the general government debt at a sustainable level will be a key challenge for fiscal and other economic policies in the coming years. General government debt and the costs of its financing are growing. Expenditure on interest is thus, given Slovenia’s obligations to correct the excessive deficit and stabilise public finances in the medium term, to a certain extent crowding out expenditure for other purposes. Risks for even faster debt growth also remain high. In the coming years, the level of general government debt may also be affected by other factors besides the need for financing the deficit and refinancing debt liabilities. Amid the growing debt problems in certain euro area countries, the increase in the yields of government bonds may spill over across the entire area, which would also raise the costs of Slovenia's borrowing. This could also be the case if Slovenia’s credit rating fails to improve. However, if financial markets lose confidence in Slovenia’s commitment to push through with the consolidation measures and the stabilisation of the financial sector, it will be even more difficult to secure funds for financing the deficit and refinancing debt liabilities. Moreover, more expensive borrowing would hurt the quality of public finances, as growing expenditure on

interest would crowd out the more flexible expenditure, which could weaken the development role of public finances. Difficulties in accessing sources of finance would also affect private sector borrowing, which would in turn deteriorate Slovenia's competitiveness and its potential for future economic development.