Slovenia: European Union Related Medium Term Public Finance Challenges

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Abstract

The paper presents medium-term fiscal challenges faced by the Republic of Slovenia upon its accession to the European Union. At the beginning, two methodological issues are discussed.

First, the difference between the calculated and actual net transfers between the EU budget and national budgets of the EU member states.

Second, typology of fiscal effects the EU funds have on a member state's national budget, both on its overall level and on its expenditure structure. The following two parts of the paper provide quantification and an analysis of effects the EU membership is expected to have on Slovenia's public finances in early post-EU accession years, i.e. in the 2004 – 2006 period, and in the period of the next medium-term financial perspective of the EU, covering the period between the years 2007 and 2013.

Keywords: *EU public finances, Slovenia, financial flows, fiscal adjustment*

JEL Classification: F36, F21

Introduction

In December 2002, Slovenia completed its EU accession negotiations, in May 2004, it became a full member of the EU, and in June of the same year the country already entered into the ERM2 with an objective to introduce the euro as early as at the beginning of 2007. The paper has two main objectives, *first,* to provide an assessment of effects the EU membership is expected to have on Slovenia's public finances[1] in early post-EU accession years, i.e. in the 2004 – 2006 period, and

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second, to discuss those challenges faced by Slovenia's public finances that are closely connected with the next medium-term financial perspective of the EU, covering the period between 2007 and 2013.

In addition to *Introduction* and *Conclusions,* the paper consists of four chapters. The *first* and *second chapters* are methodological in their character. They present the difference between concepts of the calculated and the actual net transfer between the EU budget and the national budget of an EU member state, and discuss effects the EU funds have on new member state's national budget, both on its overall level and on its expenditures structure. The next two chapters analyse expected implications of the EU accession on Slovenia's public finances. The *third chapter* focuses on the 2004 – 2006 period while the *fourth chapter* discusses the post 2006 period.

1. Calculated versus Actual Net Transfer of Funds

As in all previous EU enlargements, financial package negotiations have been left to the very end of the process. In this part of negotiations, it has been agreed that immediately upon the membership, more precisely in the 2004 – 2006 period, the new EU members would make full contributions to the EU budget reduced by a negotiated annual amount of lump-sum payments. On the other hand, these countries will be eligible to receive certain amount of funds from the EU budget for agriculture and for the structural actions. It was further agreed at the Brussels European Council in October 2002 that the *calculated* net transfer, i.e. the calculated difference between expected inflows from the EU budget to the national budget and outflows from this budget to the EU budget, should be positive for all the candidate countries in the period 2004 – 2006, and at least at the level that was achieved by an individual candidate country in the last year before its accession.

Calculated net transfers were projected on some very optimistic assumptions about the absorption and co-financing capacity of the new EU member states. As a consequence, it is very realistic to expect that *actual* net transfers to new EU member states will be lower or even significantly lower than the ones calculated for the period 2004 – 2006. The factor that will decisively influence the magnitude of the gap between the levels of the calculated net transfer and the actual net transfer for an individual country is its absorption capacity. The concept of absorption capacity is composed of two components. The first one, the „institutional or

[1] Public finances, i.e. the general government budget, of the country are composed of four major components: (i) central government budget, (ii) Pension and Disability Insurance Fund, (iii) Health Insurance Fund, and (iv) municipality budgets.

administrative capacity", is a capacity of a country to prepare and manage projects and programmes to be financed from the EU budget. The second component of the country's absorption capacity is its „financial capacity", i.e., its capacity to provide local co-financing for EU-sponsored projects and programmes.

2. Effects of the European Union Membership on Public Finances of New European Union Member States

EU membership is associated with various effects it has on public finances of new member states.[2] These effects could be broadly classified into two large groups, one of them affecting the overall balance of the national budget, and the other one affecting the expenditure structure of the national budget. Each of the two will be presented briefly in this chapter.

Effects on the Overall Balance of the National Budget

On the one hand, this group consists of effects that are a direct consequence of inflows from the EU budget into the national budget (agriculture, structural funds, etc.) and of outflows or payments from the national budget into the EU budget.

In addition to these „intra-budgetary flow effects", a new EU member state faces another group of fiscal effects, called „other effects on the overall balance of the national budget". When assessing this group of EU accession fiscal effects – it includes effects that are not reflected in financial flows between the EU budget and the national budget of that particular country – one has to distinguish between the following two sub-groups. The first one consists of so-called „pre-accession build-in effects", i.e. the fiscal effects that are associated with the assumption of the *acquis* steaming from the single market and from other EU benchmarks. This subgroup of fiscal effects, it for example includes Schengen related costs or budget subsidies for agriculture, was present in budgets of the EU candidate countries for several years before these countries actually became EU members. The second sub-group of „other effects on overall balance of the budget" called also „post-accession effects", consists of those effects that have caused a substantial change in the new EU member state's fiscal position, if periods immediately before and after the EU accession are compared. For these costs, the fiscal position of the country in 2003, i.e. in the last pre-accession year, is taken as a base year and is then compared with the estimated fiscal position of the country in the following years.

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[2] For a discussion of these effects, see, for example, Backe (2002) and Kopits and Székely (2002).

Effects on the Expenditure Structure of the National Budget

In addition to public finance effects that the EU accession has on the overall balance of the national budget of new EU member states, this process may also involve drastic changes in its expenditure structure. This is particularly the case, if a country wants to achieve simultaneously the following two objectives: (i) to keep overall national budget balance under control, and (ii) to actually draw from the EU budget resources that are earmarked for that particular country.

Several reasons explain why substantial restructuring of budget expenditures is required for new EU member states. The first one is the difference between the character of member states' contributions to the EU budget and the allocation of funds the member states receive from the EU budget. According to the *acquis*, each EU member state is obliged to make annual contributions to the EU budget. At the same time, these contributions constitute a new budget expenditure item in the national budget. On the expenditure side of the EU budget, member countries are eligible to receive funds from this budget and these funds represent budget revenue item for the national budget. However, EU budget funds may be used only for funding eligible expenses and that *de facto* means expenditures associated with two economic policies carried out at the EU level, namely the common agriculture policy and the cohesion policy. Around 85 per cent of the EU budget expenditures is allocated for these two purposes.

General character of EU member states' contributions to the EU budget together with a strong concentration of funds they receive from the EU budget in the areas of agriculture and cohesion pose a need for a new member state to restructure expenditures in its national budget. As already mentioned, funds from the EU budget are *de facto* available only to selected categories of national budget users. In case that the budget expenditures are not restructured appropriately, these users may end up with significantly more resources available – they come from the national budget as well as from the EU budget – than before the EU accession while budget users that are not eligible for EU funding may be faced with drastic reduction of available resources.

The problem of expenditure restructuring in the new EU member states is further complicated by the fact that a large majority of national budget expenditures funded from the EU budget – resources from structural funds and the Cohesion fund, resources for rural development – requires co-financing from national resources. Obligation to provide national co-financing and application of the „additionality principle"[3] in fact means that a country has to channel additional national budget resources for those expenditures – mainly agriculture and

[3] Under this principle, EU member states cannot use EU budget funds to finance projects that, in the absence of this transfer, would have been financed from the national budget.

structural operations – that are eligible for EU budget financing. If, however, the country does not provide funds for national co-financing, also the EU funding component for eligible expenditures cannot be used.

Assuming that contributions of the country to the EU budget and also resources committed in the EU budget for this particular country are fixed at the same level – each of them at 10 in the *Table 1* – the country must actually choose among one of the three main options to address the intra-budgetary financial flows issue. Each of these options is characterised by a different set of impacts on the overall national budget balance, on the calculated net balance of the country, and on the expenditure structure of the national budget.

Table 1

Options to Address Intra-budgetary Financial Flows between a National Budget and the EU Budget

Budget item	Pre-accession year	Post–accession year		
		Option A	Option B	Option C
A. Total revenues	*100*	*100*	*100*	*90*
– domestic sources	100	90	90	90
– transfer from the EU budget	0	10	10	0
B1. Total expenditures by destination	*100*	*100*	*110*	*100*
– domestic	100	90	100	90
– transfer to the EU budget	0	10	10	10
B2. Total expenditures by purpose	*100*	*100*	*110*	*100*
– investment	30	40	40	30
– other expenses	70	60	70	70
C. Budget balance	*0*	*0*	*–10*	*–10*
D. „Calculated" net balance	*0*	*0*	*0*	*–10*

Source: Based of the text of this Chapter.

Option A shows a country that is absolutely committed to keep its budgetary balance unchanged. The country also wants to use all the resources available in the EU budget and has an adequate absorption capacity to do so. Due to the co-financing and additionality principles applied for the use of EU budget resources, the country will have to restructure its budget expenditures if it wants to achieve both objectives simultaneously. Thus, relatively more funds will become available for investment purposes and relatively less for other expenditures. There will also be a shift within the structure of investment expenditures, with a growing proportion of funds channelled to investments eligible for EU financing. This option thus involves drastic restructuring on the expenditure side of the national budget.

Option B describes a country, which is again committed to use all the available EU budget resources. On the other hand, however, the country is either not willing or not able to introduce changes in the structure of its budget expenditures.

As other budget expenditures remain unchanged, increase of investments needed due to the co-financing and additionality principles can only be achieved through the increase of the overall level of budget expenditures. As a consequence, the country enters into a budget deficit.

Option C deals with a country that in contrast to the above two options – in both alternatives countries are committed to draw EU funds and consequently have favourable net balance *vis à vis* the EU budget – does not pay attention to drawing of resources from the EU budget or simply has a weak absorption capacity. If the country is for whatever reason also not ready to undergo structural changes in its budget expenditures, it will end up with double deficits. The country will enter into a budget deficit and at the same time it will become a net payer to the EU budget. If, however, the country embarks on budget expenditure structural changes, then it has a chance to escape the budget deficit, but it will nevertheless experience a net outflow of funds to the EU budget.

3. European Union Related Fiscal Effects on Slovenia's Public Finances in the 2004 – 2006 Period

Intra-budgetary Flow Effects

According to the financial package agreed in the negotiations between Slovenia and the EU member states, Slovenia's calculated net flow should remain positive.

Table 2

Outcome of the EU Financial Package Negotiations Including Calculated Net Balance, 2004 – 2006 (in EUR million)

Calculated pre–accession aid 2003 (EUR 45 million)				
	2004	**2005**	**2006**	**Total**
A. Calculated inflows from EU budget into Slovenia's budget	**224**	**285**	**324**	**833**
– Pre–accession aid	51	43	27	121
– Agriculture	43	124	157	324
– Structural actions	27	59	73	159
– „Schengen facility" and other	38	38	38	114
– Internal actions	12	21	28	61
– Cashflow lump sum compensations	52	–	–	52
B. Calculated outflows from Slovenia's budget into EU budget	**–187**	**–288**	**–296**	**–771**
– Traditional own resources	–18	–29	–29	–76
– VAT resource	–22	–35	–36	–93
– GNP resource	–129	–198	–203	–530
– UK rebate	–17	–27	–28	–72
C. Calculated net balance before budgetary lump sum compensation	**37**	**–3**	**28**	**62**
D. Budgetary compensation	**43**	**85**	**54**	**182**
E. Calculated net balance after budgetary lump sum compensation	**80**	**82**	**82**	**244**
F. Calculated net balance after budgetary lump sum compensation (% of GDP)	**0.4**	**0.4**	**0.4**	

Source: EU Commission, 17 December 2002.

As shown in *Table 2,* net inflow is expected increase from EUR 45 million in the last pre-accession year to around EUR 80 million or 0.4 per cent of GDP in each year of the 2004 – 2006 period. As far as the actual net flow figures are concerned, they will only be available ex-post.

Other Effects on the Overall Balance of the National Budget

Over the five year period prior to accession to the EU, Slovenia has significantly increased its budget expenditures aimed at reaching *acquis* requirements. Among these „pre-accession build-in effects", by far the most important were Schengen related costs, and budget subsidies for agriculture. Their aggregate amount was estimated at an annual level of around 1 per cent of GDP in the pre-accession years. This segment of EU related fiscal costs, did not contribute to major changes in the overall fiscal position of the country in the period immediately upon the EU accession.

The second sub-group of „other effects on the overall balance of the budget" are „post-accession fiscal effects". In the case of Slovenia, these effects are expected to be a result of the following two sets of reasons: (i) on the budget revenues side, they will occur due to expected changes in VAT collection efficiency[4] and the expected decline of customs duties, and (ii) on the budget expenditures side, they are expected emerge due to expenditures associated with the Schengen-related costs, „top-up" mechanism of direct payment,[5] and contributions to the EU institutions.[6] *Table 3* provides an overall quantification of the „post-accession fiscal effects" in Slovenia. The Table shows that fiscal position of the country will worsen in the 2003 – 2005 period as a result of these effects.

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[4] Before accession to the EU, VAT was a very important budget revenue source in Slovenia. Its administration was relied heavily on data about export and import of goods. Upon accession to the EU, this crucial mechanism of VAT administration was eliminated. Instead, the country has joined the VAT Information Exchange System that has been established to provide an institutional mechanism for an efficient VAT audit. Unfortunately, the System has been facing substantial difficulties with respect to obtaining information about transactions made between tax-payers within the EU. For Slovenia, the entrance into the System has *de facto* meant abolishing its very efficient VAT collection mechanism based on export and import administration and becoming dependent on the less efficient VAT administration mechanism based on exchange of information among the EU member states. The expected drop of the VAT budget revenue is therefore a consequence of the country's accession to the EU and this means a clear example of „post-accession fiscal effects".

[5] According to the Common Agricultural Policy (CAP), farmers in the EU are entitled to various forms of direct payments paid from the EU budget. Taking into account that in the 2004 – 2006 farmers in new member states will be entitled to receive from the EU budget only a portion of funds available to farmers in the existing member states (25 per cent in 2004, 30 per cent in 2005 and 35 per cent in 2006), new member states were given a possibility to „top up" these funds with financial resources from their national budgets. How much they are allowed to „top up" from national budget has been agreed in the EU accession negotiations.

[6] From the day of accession to the EU, the new member states automatically became members, i.e. shareholders of the European Investment Bank. In addition, they had to start contributing to the European Development Fund and to some other EU organizations.

In 2004, Slovenia's central government budget deficit was expected to be by about 0.4 percentage points of GDP higher than in 2003 as a consequence of „post-accession fiscal effects". The deterioration was caused primarily by reduced budget revenues due to decrease of VAT collection and drop in customs duties, and only to a minor extent by the increase on the budget expenditure side. The later include contributions of Slovenia to the EU institutions and a slight increase of „top up" payments for agriculture *vis à vis* its 2003 level. Both, Schengen related costs and „top up" payments in agriculture have been substantially phased-in into Slovenia's budget already in the pre-accession period.

Table 3

„Post-accession Fiscal Effects" of Slovenia's Accession to the EU (in % of GDP)*

Impact on budget	Base year 2003	2004	2005	Difference 2004 – 2003	Difference 2005 – 2003
Budget revenues	**9.90**	**9.50**	**9.20**	**–0.40**	**–0.70**
– VAT collection	9.31	9.11	8.95	–0.20	–0.36
– Customs duties	0.59	0.39	0.25	–0.20	–0.34
Budget expenditures	**0.78**	**0.80**	**0.61**	**–0.02**	**+0.17**
– Schengen related costs**	0.35	0.30	0.23	+0.05	+0.12
– „Top up" mechanism	0.43	0.46	0.34	– 0.03	+0.09
– EU institutions	0.00	0.04	0.04	–0.04	–0.04
Total				**–0.42**	**–0.53**

* Minus means deterioration of the fiscal position vis à vis the year 2003 while plus means its improvement.
** Excludes expenditures to be covered from the EU budget.

Source: Authors calculations from various internal sources prepared for EU accession negotiations.

In 2005, the first full year of membership in the EU, negative „post-accession fiscal effects" will increase to 0.5 percentage points of GDP *vis à vis* the year 2003 with deterioration emerging exclusively from further decline of budget revenues, the budgetary expenditure side is, on the contrary, expected to have even positive „post-accession fiscal effects". The reasons for the shift on the expenditure side are twofold. First, declining Schengen related costs to be financed from Slovenia's budget as major border investments will be more or less terminated by that time. Second, „top up" payments from Slovenia's budget for agriculture are expected to peak in 2004 while in the following years they will be – due to the beginning of the EU co-financing – already lover than in 2003.

Effects on the Expenditure Structure of the National Budget

Over the last few years, Slovenia has pursued a prudent fiscal policy with a general government deficit at an annual level below 2 per cent of GDP.[7] With a clear objective of meeting all Maastricht criteria by mid-2005, the authorities have decided to continue with a tight budgetary policy. The general budget

[7] The only exception was 2002 when the deficit amounted to close to 3 per cent of GDP.

deficit is expected to remain well under control with projected level of 1.9 and 1.8 per cent of GDP in 2004 and 2005, respectively (Convergence programme), as shown in *Table 4*. The authorities are also committed creating an environment facilitating smooth absorption of the EU budget funds allocated to Slovenia during its EU accession negotiations and therefore to bring the actual net inflow from the EU as close to the calculated net inflow as possible.

Based on the above, it is possible to make a conclusion that among the three options presented in the Chapter 2, Slovenia aims to apply the *Option A* in the early post-EU accession period. Since the country remains committed to its both key objectives in the fiscal area, i.e. to continue with strict budget discipline and to create conditions required for high absorption of funds from the EU budget, it opted for significant changes in the expenditure structure of the general budget.

The two key EU accession-related features of expenditures in Slovenia's general government budget for 2003, as the last pre-accession year, 2004 as the first incomplete EU accession year, and 2005 as the full EU accession year are clearly visible in the *Table 4*.

Table 4

Structure of General Government Budget of Slovenia, 2003 – 2005 (in per cent)

Budget item	2003*	2004	2005
A. Total revenues	*100.0*	*100.0*	*100.0*
– domestic sources	100.0	96.9	96.4
– transfer from the EU budget	0.0	3.1	3.6
B1. Total expenditures by destination	*100.0*	*100.0*	*100.0*
– domestic	100.0	98.3	97.4
– transfer to the EU budget	0.0	1.7	2.6
B2. Total expenditures by purpose	*100.0*	*100.0*	*100.0*
– „Flexible" expenditures (investments and subsidies)	8.4	10.1	9.7
– „Fixed" expenditures (other expenses, including salaries and material costs)	91.6	89.9	90.3
C. Budget balance (% of GDP)	*–1.8*	*–1.9*	*–1.8*
D. „Calculated" net balance (% of GDP)	*0.0*	*0.6*	*0.5*

* Does not take into account inflow of pre-accession funds from the EU budget.

Sources: Bulletin of Public Finance. Ministry of Finance, October 2003 (for A and B1), Convergence Programme, May 2004 (for B2 and C), and Budget Memorandum of the Republic of Slovenia for 2004 and 2005 (for D).

First, the expenditure side of the general government budget, and even more so of the central government budget, will become more development oriented, as the share of „flexible" expenditures, i.e. investment expenditures and subsidies, is expected to increase, while the share of other „fixed" expenditures, such as salaries and material costs, is expected to decline. Second, since the accession to the EU, transfers between the EU budget to the Slovenian general budget have become an integral part of the country's general government budget. In 2005, for example, transfers from the EU budget are expected to contribute almost 4 per cent to total general government revenues and more than 2.5 per cent to total general government expenditures. These proportions are significantly higher if financial flows with the EU budget are compared with the central government's budget.[8]

4. Expected EU Related Fiscal Effects on Slovenia's Public Finances in the Post 2006 Period

Intra-budgetary Flow Effects

In February 2004, the European Commission presented a document laying out policy challenges and budgetary means of the enlarged EU for the period 2007 – 2013. The document is a reasonable compromise between the „continuity scenario" based on the assumption that the existing EU policies will remained largely unchanged in the next medium-term period, and the „radical scenario" based on the assumption of drastic structural changes in the EU policies as advocated in the Sapir report (Sapir, 2004). The Commission's document honours the existing agreements, including the agriculture agreement reached in Brussels in October 2002, and tries to accommodate the defined strategic goals of the EU, particularly the Lisbon strategy, cohesion after enlargement and common foreign and security policy. In order to meet these policy challenges, the European Commission proposes that the required expenditures over the 7-year period would be at a level of 1.14 per cent of EU GNI (COM (2004)101).

Building on its February 2004 document and on the debate among the EU member states that followed, the European Commission presented this July the first set of detailed proposals setting out the legal framework for some key areas of the next financial perspective. As a part of this documentation, the Commission also presented – for the first time – its preliminary calculations about the projected calculated net balances for individual EU member states in the next financial perspective. According to these calculations, Slovenia is expected to be a net recipient of funds at an average annual level equivalent to 1.3 per cent of its GDP throughout the 2008 – 2013 period (IP/04/908). This is not only a significant increase over the comparable figures for Slovenia in the 2004 – 2006 (see Chapter 3), but is also broadly in line with the calculated net balances of some other EU member states – old ones and new ones – that are at the level of economic development comparable to Slovenia.

[8] In 2005, transfers from the EU budget are expected to participate with more than 6 per cent in the central government's revenues and with more than 4 per cent in central government's expenditures.

There are two main factors that explain why the calculated net balance for Slovenia in the next financial perspective, as calculated by the European Commission, is significantly more positive than in the 2004 – 2006 period. First, in the 2004 – 2006 period, new EU member states are being „phased-in" for the use of funds for structural actions at very different levels. This level is much higher for less-developed new EU member states, like the Baltic states, than for the more developed new members, including Slovenia. In the next financial perspective, all new EU member states will be fully „phased in" for the use of these resources. As a consequence, Slovenia is expected to have an access to close to three times more funds from the EU budget for structural actions than in the final year of the present financial perspective. Second, in the next financial perspective, the gradual „phasing in" for direct payments will continue. As a consequence, new EU member states including Slovenia will be entitled to significantly larger volume of funds for agriculture than under present financial perspective.

Required Restructuring of Slovenia's General Government Expenditures before the Next Medium-term Financial Perspective of the European Union

The next EU medium-term financial perspective covering the period 2007 – 2013 will expose Slovenia's public finances to additional challenges. It has been mentioned above that in this period Slovenia can expect to have access to roughly three times more funds than in 2006, i.e., in the final year of the present financial perspective. As drawing resources from the EU budget is conditional on the provision of co-financing from the national sources – public and/or private – Slovenia will be faced with a necessity to put aside significantly more resources for co-financing of EU-sponsored projects and programmes than is the case in the period till 2006.

If Slovenia wants to continue applying *Option A,* i.e. to keep its budgetary balance unchanged or even to improve it and to use all resources available in the EU budget also in the period from 2007 on, it will have do drastically restructure the expenditure side of its general government budget. This will be particularly difficult because of extremely rigid structure of expenditures in Slovenia's general government budget. Roughly 90 per cent of them can be classified as „fixed" expenditures, meaning that they cannot be reallocated without the change of legislation. Consequently, the share of so-called „flexible" expenditures that can be reallocated relatively easily and includes many development oriented expenditures is rather small.

Table 5 provides a simulation of the structural changes in Slovenia's general government budget expenditures in the 2005 – 2007 period required if the country wants to achieve simultaneously two objectives, first, to continue with its conservative fiscal policy, and second, to be ready for drawing all the available resources from the EU budget from the beginning of the next financial perspective.

Table 5

Simulation of Structural Changes in Slovenia's General Government Expenditures due to the Next Financial Perspective of the EU

Item	2005	2007	
		Alternative A	Alternative B
A. GDP (2004 prices; SIT billion)	6.502	7.012	7.012
B. General government expenditures (2004 prices; SIT billion)	2.971	3.204	3.204
– „Fixed" (material costs, salaries, etc.)	2.674	2.863	2.884
– „Flexible" (investments and subsidies)	297	341	320
– Co-financing of EU sponsored programmes and projects	26	70	70
– Financing of „domestic" programmes and projects	271	271	250

Source: Convergence Programme, Document of the European Commission IP/04/908, and own assumptions.

The simulation is based on the following facts and assumptions: (i) forecasts for annual real growth rates of GDP for the 2005 – 2007 period are taken from the Convergence Programme: 3.7 per cent in 2005, 3.8 per cent in 2006 and 3.9 per cent in 2006; (ii) the share of general government expenditures in GDP is assumed to remain unchanged at 45.7 per cent in the 2005 – 2007 period (the data for 2005 is taken from the Convergence Programme); (iii) „Fixed" expenditures, including all the expenditures but investments and subsidies, are expected to account for 90 per cent of total general government expenditures in 2005, according to the Convergence programme; and (iv) based on the European Commission's calculations of the net balance position of Slovenia in the next financial perspective as of July 2004 (IP/04/908) and on the internal calculations prepared in Slovenia, it is expected that the country will have access to funds from the EU budget equivalent to around 3 per cent of its GDP in 2007. This means that Slovenia will need for co-financing – an average share of 25 per cent[9] – an equivalent of 1 per cent of its GDP of national budgetary resources or SIT 70 billion in nominal terms. In 2005, the comparable figures are 0.4 per cent of GDP and SIT 26 billion.

Comparing the structures of general government expenditures in 2005 and 2007 presented in the *Table 5,* one can find out that in 2005 the national co-financing of EU sponsored programmes and projects is expected to account for 8.8 per cent of total „flexible" expenditures, while by the year 2007, this share is expected to increase to over 20 per cent.

In order to accommodate this increase, the country will have to embark on of the following two conceptual alternatives.[10] The first one – *Alternative A* – is

[9] Typical shares of national co-financing are 25 per cent for transfers from the structural funds, 15 per cent for funds from the Cohesion fund, 20 per cent for funds for rural development (Antzcak, 2003; Hallet, 2004).

based on the assumption that the country will not allow squeezing out those „flexible" expenditures that are not eligible for EU funding. This means that financing of „domestic" programmes and projects will remain at nominally the same level between 2005 and 2007. Under this alternative, the squeezing out is expected on the side of „fixed" expenditures, as the share of total „flexible" expenditures would increase from 10.0 per cent to 10.6 per cent of total general government expenditures in the 2005 – 2007 period. The extent of the squeezing out of „fixed" expenditures under this alternative depends crucially on the GDP growth rate. The lower the growth rate the larger the squeezing out.

The second alternative – *Alternative B* – assumes that there will be no change in the basic structure of general government expenditures. The relationship between „fixed" and „flexible" expenditures is expected to remain at an unchanged ratio of 90 : 10 between 2005 and 2007. Under this alternative, the restructuring of budget expenditures will be restricted to changes within the structure of its „flexible" part. More specifically this means that financing of „domestic" programmes and projects will be drastically cut, even in nominal terms, in order to fully accommodate significantly increased requests for co-financing of EU-sponsored programmes and projects.

While both alternatives are consistent with the country's public finance objective, i.e. to keep general government deficit well within Maastricht limits, they do have a very different developmental potential. With increased „flexible" portion of the expenditures to be used for both, co-financing of EU sponsored programmes and projects as well as for financing of „domestic" development priorities, *Alternative A* bodes well for higher economic growth of the country and therefore for faster real convergence with the EU average. Of course, embarking on this alternative would require a political commitment for more restrictive „fixed" expenditures policy. On the other hand, *Alternative B* does not require significant adjustments in expenditures policy, and is, at least in theory, easier to be implemented. This alternative, however, does not have a strong development potential, as one group of investments – financing of „domestic" programmes and projects – will be simply replaced with another group of investments – co-financing of EU sponsored activities. In addition, this kind of an investment switch is hardly possible in practice for both, economic and political reasons. A much more realistic assumption for the country embarking on this alternative is that it will either not draw in full the funds available in the EU budget or it will increase budget expenditures required for co-financing of EU-sponsored programmes and therefore fuel the budget deficit.

[10] In practice, it can also design and implement its own restructuring programme that will, in fact, be a combination of the two conceptual alternatives.

Conclusions

Overall Volume of EU Related Fiscal Effects for Slovenia

For Slovenia, overall fiscal effects of the EU accession will be more or less neutral in the years 2004 and 2005 if the calculation takes into account only „intra-budgetary flow effects“ and „post-accession effects“. As far as the „intra-budgetary flow effects“ are concerned, they are expected to be positive and at an annual level of around 0.4 per cent of GDP. In contrast, „post-accession“ are expected to have negative fiscal effects on Slovenian public finances in early post accession period, especially due to reduced budget VAT revenues and customs duties. The magnitude of these effects is estimated at an annual level of 0.5 per cent of GDP. If, however, „pre-accession build effects“, such as „top up“ payments in agriculture and Schengen related expenditures, are introduced into the calculation, then the overall fiscal effects of Slovenia's accession to the EU will be negative at a level of around 1 per cent of GDP in the first two years upon the accession to the EU. The outcome may be even more negative in case that the country will not be successful in absorbing EU budget funds committed to it during the EU accession negotiations.

As far as the post 2006 period is concerned, Slovenia is expected to have a calculated net inflow from the EU budget at an average annual level of around 1.3 per cent of its GDP during the next medium-term financial perspective of the EU. The expected increase in the existing financial perspective is primarily a consequence of the fact that in the 2004 – 2006 period Slovenia is being „phased in“ for the use of funds for structural actions to a much lover extent than both, the eligible old EU member states and also the less-developed new EU member states.

Changes in the Expenditure Structure of Slovenia's Public Finances

Accession to the EU has involved also significant changes in the structure of Slovenia's public finances, if the country wants to achieve simultaneously the following two objectives: (i) to keep overall general government budget deficit within Maastricht limits, and (ii) to draw the committed resources from the EU budget. In 2004 and 2005, Slovenia initiated significant restructuring of its general government expenditures. Through this process, Slovenia's public finances will become more development oriented as the share of „flexible“ expenditures, i.e. investment expenditures and subsidies, is expected to increase, while the share of other „fixed“ expenditures, such as salaries and material costs, is expected to decline.

In view of extremely rigid structure of general government expenditures with the share of „fixed“ expenditures as high as 90 per cent, pressure for further expenditure restructuring will intensify in the following years, if the country wants to be ready for effective absorption of significantly increased volume of funds from the EU budget available to Slovenia in the post 2006 period. In order to accommodate the expected increase of funds to be available from the EU budget, the restructuring of the general government expenditures will have to be based on one of the two conceptual alternatives; on a development-oriented alternative aimed at increasing the relative proportion of „flexible“ expenditures *vis à vis* the „fixed“ ones, or on an alternative focused merely on switching the structure of „flexible“ expenditure in favour of co-financing EU-sponsored activities and against the financing of „domestic“ programmes and projects.

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