REPUBLIC OF SLOVENIA
FISCAL COUNCIL

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Assessment of sustainability and compliance of the fiscal policy with the fiscal rules

based on the draft amendment to the Stability Programme and the proposed framework for the preparation of the general government budgets for the 2018–2020 period

Pursuant to the Fiscal Rules Act (ZFisP, Official Gazette of the Republic of Slovenia (Uradni list RS), No. 55/15, points (2) 1 and (2) 8 of Article 7), the Fiscal Council is obliged to submit its opinion on the Stability Programme and on the amendments to the framework regarding sustainability and compliance of the fiscal policy with the fiscal rules.

Below an assessment of the fiscal policy on the basis of the draft amendment to the Stability Programme 2017 and the proposal for amendments to the Ordinance on the framework for the preparation of the general government budgets for the 2018-2020 period are presented; it was also prepared by using data and analyses from the Institute of Macroeconomic Analyses and Development, because the Fiscal Council only started to operate on 22 March of this year.

Summary assessment

The Fiscal Council assesses that the draft amendment to the Stability Programme 2017 and the proposal for amendments to the framework for the preparation of the budgets have been drawn up in accordance with the rule on the limitation of the headline deficit below 3% of GDP and the debt rule. An assessment of compliance with the expenditure rule cannot be made on the basis of data contained in the draft amendment to the Stability Programme 2017.

The Stability Programme and the Ordinance envisage a structural effort that is too low with regard to EU rules and significant foreign and domestic risks. Moreover, the Stability Programme does not define the measures to achieve such an effort with sufficient precision.

The Fiscal Council expects that in 2017 the Government of the Republic of Slovenia will prepare a set of additional measures accounting to 0.2% of GDP for 2017 so as to achieve an average structural effort of 0.6% of GDP in 2016 and 2017 or at least an appropriately increased fiscal effort for 2018 and 2019 by 0.2% of GDP in these two years. In this respect it must also be considered that in 2016 a significant part of the structural effort was achieved through a substantial drop in the utilisation of EU funds and investments respectively, which does not provide a solid foundation for the fiscal balancing.

In the Stability Programme and in the framework for the preparation of the budgets in the following years, public expenditure must be limited so as to achieve the structural balance objective already in the middle of the programme period and to maintain it in the following years when the upper limit of the planned level of expenditure referred to in Article 3 of the Fiscal Rules Act must be taken into consideration.

Economic trends were favourable in 2016. Forecasts made by most institutions indicate that Slovenia will undergo a transition in 2017 towards a positive output gap, which will persist in the following years. Accordingly and in compliance with the commitments within international treaties Slovenia should limit expansionary government incentives to avoid the overheating of the economy. Since (i) forecasts currently indicate that the positive production gap will not turn out to be significant, (ii) the risks of macro-economic projections are estimated as balanced and (iii) economic growth will be normal with regard to the rules of the Stability and Growth Pact, limitations in fiscal policy can be undertaken in a gradual manner that is still friendly to economic growth. However, in periods of favourable growth it is urgent to create a space for fiscal policy needed in the materialisation of significant negative foreign and domestic risks and in the less favourable part of the cycle.

The draft Stability Programme is set so as to deviate from the rules regarding the structural deficit and therefore does not provide a relevant space. This can undermine confidence in the stability of public finances and have an unfavourable impact on the position of the Government in financial markets with higher interest spreads. Most of all, measures for improving the structure of expenditure and its limitation must be defined in more detail.

Compliance with rules

The general government deficit dropped to 1.6% of GDP in 2016. If negative risks do not occur in 2017 and in the following years, it can be expected with regard to the available projections that Slovenia will respect the rule of the deficit limit of 3% of GDP.

As a rule, the growth of government expenditure should not exceed the potential growth reduced by the convergence margin to approach the medium-term objective. In the final years of the programme period, when Slovenia should already have reached structural balance, the level of expenditure referred to in Article 3 of the Fiscal Rules Act should be taken into consideration. Assessments of compliance with the expenditure rule cannot be made on the basis of data contained in the draft amendment to the 2017 Stability Programme and the medium-term framework.

According to the rules of the Stability and Growth Pact, in the period when the economy faces a positive output gap not exceeding 1.5% and when the general government debt exceeds 60% of GDP, the structural deficit should be reduced by at least 0.6% of GDP until the structural balance is achieved. The deviation from the required fiscal effort is significant, if the deviation amounts to 0.5% of GDP or more per year or if it amounts to 0.25% of GDP in an average of two consecutive years.

The fiscal effort envisaged in the amended Stability Programme will amount to 0.2% in 2017 and to 0.3% in 2018. As the measures for its reduction are not defined precisely enough, we believe that there is a risk of a significant deviation from EU rules regarding the structural deficit this year and a significant deviation at the level of two-year average. In this respect it should be noted that the major part of the structural effort is achieved through envisaged one-off factors. The Stability Programme namely assumes one-off factors amounting to 0.4% of GDP in 2017 and 2018.

In the transitional period the debt rule means that in an average of three years after the withdrawal from the procedure of excessive government deficit the debt must be reduced by 1/20 of the difference to 60% of GDP or a minimum structural adjustment (MLSA) providing such a reduction must be undertaken. With regard to the draft Stability Programme this rule is supposed to be fulfilled if negative risks do not occur. This in general, is also supported by the reduction of buffers originating from pre-financing and not just by "the actual" structural reserve.

Macro-economic assumptions

In respect of the statements made in the document "Stability Programme, amendment 2017 – first draft" that should serve to support the thesis that the economy is not overheating, the following must be taken into consideration:

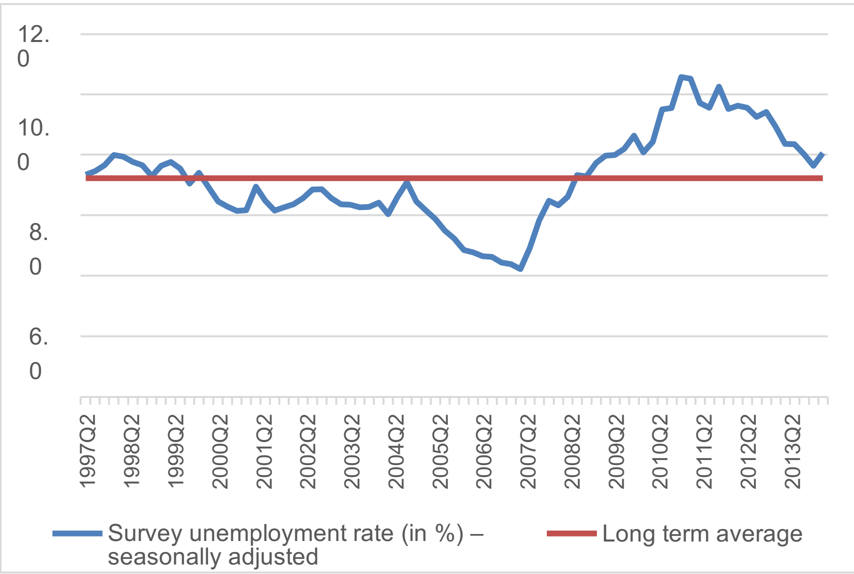
1. The registered unemployment rate dropped below the longer-term average.

Figure: Registered unemployment rate, Slovenia:

Source: SURS, Employment Service of Slovenia (ZRSZ), calculations by IMAD.

2. Last year the survey based unemployment rate was dropping towards the long-term average, but increased at the end of the year. The recent forecasts that consider the latest macroeconomic data indicate that this year the survey based unemployment rate will be below the long-term average.

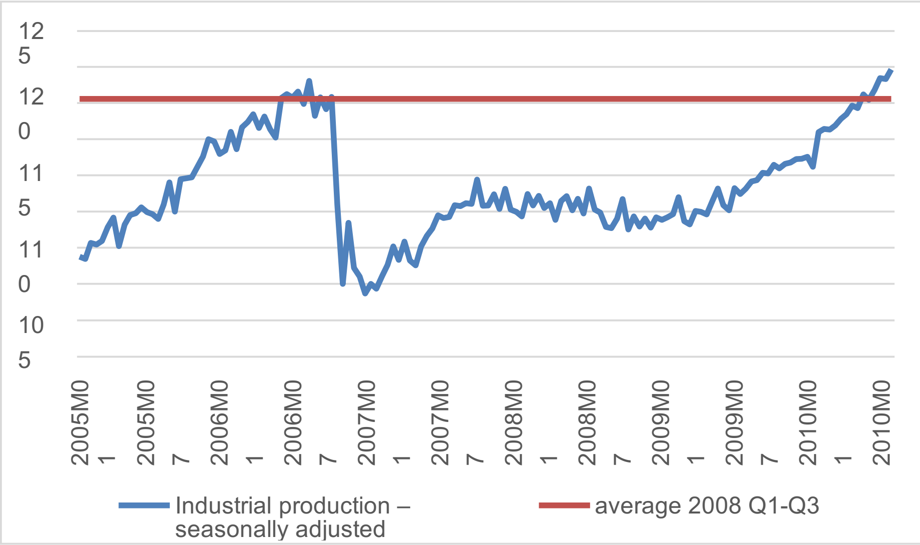
Figure: Survey unemployment rate, Slovenia:



Source: SURS, calculations by IMAD.

3. Apart from unemployment-related data also data on industrial production that exceeded the 2008-level at the beginning of this year must be considered.

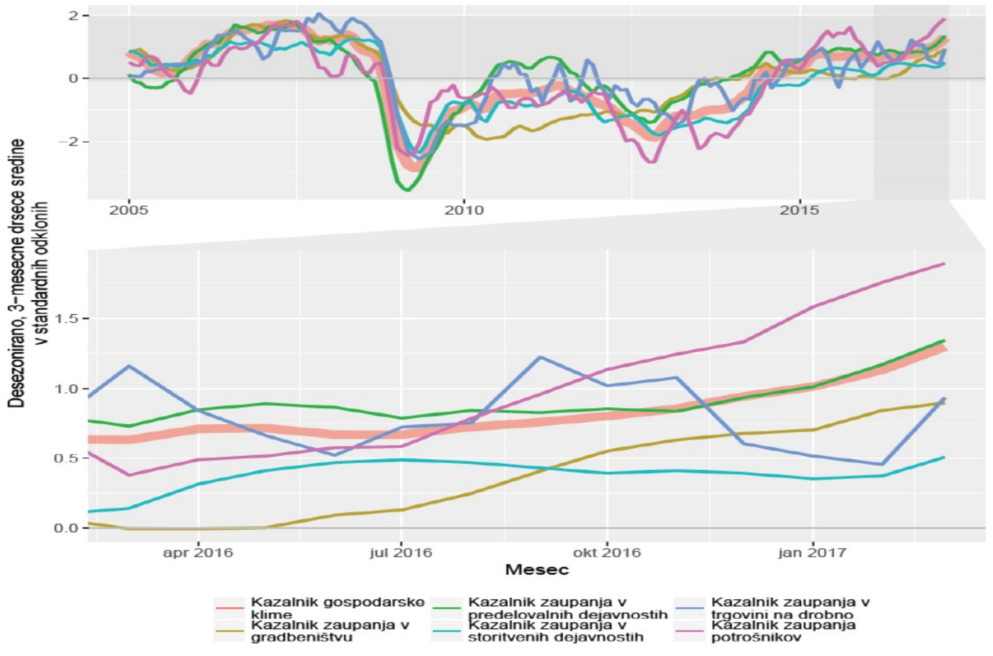
Figure: Industrial production, Slovenia:



Source: SURS, calculations by IMAD.

4. At the beginning of 2017 business tendency indicators that are often used in macroeconomic practice as business cycle indicators (OECD) [Business Tendency Surveys, available at: https://www.oecd.org/std/leading-indicators/31837055.pdf](https://www.oecd.org/std/leading-indicators/31837055.pdf)) all exceeded the long-term average; three of them were even more than one standard deviation above it.

Figure: Development of confidence and economic climate indicators in different sectors of the economy



Vir: SURS, preračuni Ministrstvo za finance

These indicators indicate that in the following years the economy is at a risk of overheating.