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FISCAL COUNCIL

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Assessment by the Fiscal Council:

Compliance of the general government budget with the fiscal rules in 2016

On the basis of the review of the macroeconomic conditions and the developments in public finances the **Fiscal Council assesses that in 2016 Slovenia complied with the fiscal rules** that apply in periods in which the country has not yet achieved its medium-term fiscal objective. The structural effort exceeded 0.5 percentage points of GDP in 2016 and was thus at the limit or exceed the adjustment limit (0.6 percentage points of GDP) required by the preventive arm of the Stability and Growth Pact from an EU Member State that has not yet achieved its medium-term fiscal objective. In 2016 Slovenia complied with the expenditure rule and the rule of gradual debt reduction that apply in the preventive arm of the Stability and Growth Pact, or in the transitional period after leaving the excessive deficit procedure (EDP). Compliance with the expenditure rule is to a great extent the result of low investments due to the weak absorption of EU Funds and lower capital transfers related to the operation of the Bank Assessment Management Company (BAMC). Compliance with the rule of gradual debt reduction was reached in particular through the reduction of deposits accumulated in the preceding years while borrowing under favourable financing conditions. The permanent improvement of the state of public finances has therefore not yet been achieved in 2016, although the fiscal rules were complied with along with the consideration of the aforementioned factors.

Table 1: Summary of compliance with the fiscal rules in 2016

	Required	Achieved	Compliance	Deviation (% of GDP)	Deviation (EUR million)	Considerable deviation
A. Fiscal position						
Structural balance (% of GDP)	0,25	-1,4 / 1,5*	MTO not yet achieved	-	-	-
B. Structural adjustment						
I. Change in structural balance						
One-year change (p.p. of GDP)	0,6	0,5 / 0,9*	YES	-0,1 / 0,3	-40 / -	NO / -
Two-year change (p.p. of GDP)	(the rule does not apply – EDP I 2015)			-	-	-
II. Expenditure rule						
One-year change (%)	0,4	-0,1	YES	-	-	-
Two-year change (%)	(the rule does not apply – EDP I 2015)			-	-	-
C. Debt adjustment	82,2	79,7	YES	-	-	-
MLSA	82,2	79,7	YES	-	-	-
Change in debt (p.p. of GDP)	-1,2	-3,5	YES	-	-	-

Note: *Two assessments are presented with regard to two different definitions of the average (see Figures 4 and 5).

Source: Fiscal Council.

According to indent 4 of point 2 and indent 3 of point 3 of Article 7 of the Fiscal Rules Act (ZFisP) **the Fiscal Council is obliged to submit an assessment of the compliance of the general government budget from the previous year with the fiscal rules.** On 19 June 2017 the Statistical Office of the Republic of Slovenia (SORS) submitted to the Fiscal Council at the request of the Ministry of Finance of the Republic of Slovenia data on the consolidated balance sheets of the general government from the Non-financial Accounts of the General Government and from Reports on the Government Deficit and Debt for 2016. On the basis of these data and its own assessment of the macroeconomic situation in Slovenia, the Fiscal Council herewith provides an assessment of the compliance of the general government budget from 2016 with the fiscal rules.

Article 15 of the ZFisP stipulates that state budgets shall be deemed balanced in the medium term if the structural balance of the general government approaches the medium-term fiscal objective in accordance with the dynamics determined on the basis of the Stability and Growth Pact. This applies to periods when the medium-term fiscal objective (currently: surplus at the level of 0.25% of GDP) has not yet been achieved. Since the structural balance in Slovenia showed a deficit with regard to the estimates available in 2016 (according to the average of the institutions preparing these assessments, at a level of slightly below 1.5% of GDP) the rule on structural balance reduction by 0.6 percentage points of GDP applies in 2016.

1. Macroeconomic conditions in 2016

The macroeconomic conditions in Slovenia were favourable in 2016 and supported the consolidation of public finances. Gross domestic product (GDP) increased by 2.5% at fixed prices and by 3.1% at current prices. GDP increased for the third year in a row in 2016 and the year was also marked by a significant increase in the tax base. Not only did compensation of employees increase at a level of around 4.5% in 2016, but after several years of decline and modest growth also the total domestic and final domestic consumption increased by around 2.5-3% in nominal terms. The main reason was an increase in household expenditures, although solid export growth remained the main reason for economic growth. Gross fixed capital formation slightly dropped due to the decline in general government investment. The decline in general government investment was in particular a result of the high absorption of EU funds at the end of the 2015 Financial Perspective and the stagnation in the absorption of funds during the transition to the new perspective. Along with the positive terms of trade, export growth, which overtook the pace of recovery of domestic consumption, contributed to a current account surplus. The employment increased by 2% in 2016. Wages continued to grow and in the overall economy wage growth exceeded the rate of productivity growth. The average annual increase in gross wage per employee continued to be modest, while wage increases in the public sector exceeded that of the private sector. Consumer prices slightly dropped in the year on average, although mainly the increase in the prices of raw materials caused an annual inflation rate increase at the end of the year.

Macroeconomic imbalances continued to be reduced in 2016, while data indicate the possibility of existence or cumulation of certain bottle-necks in the labour market. Data on non-financial accounts indicate that the surpluses or deficits of savings decreased in all national economic sectors. This applies to the private sector where mainly the surplus of savings over investments in non-financial corporations decreased, as well as to the general government sector where the surplus of investments over savings decreased – the general government balance will be dealt with in more detail in Chapter 2. Non-financial corporations continued with the deleveraging process, which has been to a great extent completed in most sectors of the economy; however, the quality of the sources of financing of these corporations continued to improve. The quality is mainly evident in the increased importance of long-term sources of financing and their dispersion, in particular towards their own sources and the financing with the issuance of debt securities. According to the labour force survey, the unemployment rate dropped by one percentage point and reached 8.0% in 2016. This was still above the unemployment rate in the period of stable economic growth in the years preceding the crisis. However, some indicators, in particular survey-based, indicate a growing shortage of labour force with appropriate qualifications. Core inflation has remained at relatively low levels of around 1% and there are no signs of excessive domestic demand.

Table 2: Basic macroeconomic data

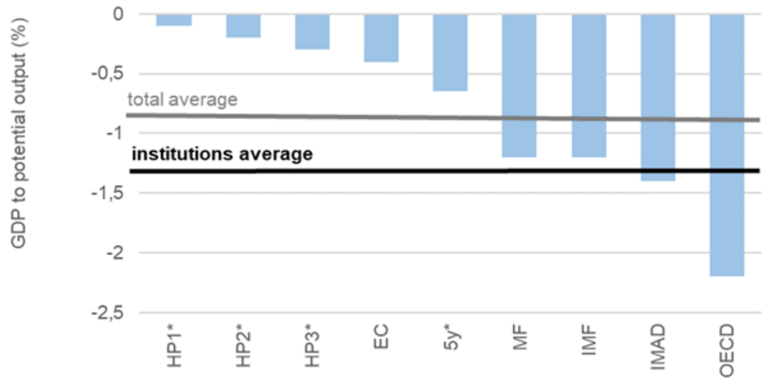
growth level in %, if not otherwise indicated	multi-annual average	2012	2013	2014	2015	2016
GDP (in real terms)	2,5	-2,7	-1,1	3,1	2,3	2,5
Labour productivity	2,3	-1,8	0,0	2,6	1,2	0,5
	contribution to GDP growth					
Domestic consumption (in p.p.)	2,0	-5,6	-1,9	1,7	1,3	2,2
External trade balance (in p.p.)	0,5	3,0	0,8	1,4	1,1	0,3
Employment	0,2	-0,9	-1,1	0,4	1,1	2,0
Unemployment rate (ILO; %)	7,7	8,9	10,1	9,7	9,0	8,0
Average wage growth (in nominal	4,1	0,1	-0,2	1,1	0,7	1,8
Current account balance (% of GDP)	0,1	2,2	4,4	5,8	4,4	5,3
Goods and services export (in real	6,3	0,6	3,1	5,7	5,6	5,9
Goods and services import (in real	5,5	-3,7	2,1	4,2	4,6	6,2
Inflation	2,7	2,6	1,8	0,2	-0,5	-0,1

Source: SORS, calculations by the Fiscal Council

On the basis of macroeconomic developments and on the basis of the estimates available on the output gap the Fiscal Council assesses that Slovenia still finds itself in a negative output gap. According to the estimates of all institutions assessing the output gap it was still negative in 2016. Differences between the output gap estimates are expected due to the different methodologies and different input data. In determining the economic situation, it must be taken into consideration that output gap estimates might change significantly over time. According to the estimates made by two Slovenian institutions, IMAD (Spring Forecast of Economic Trends 2017) and the Ministry of Finance (Stability Programme – Amendments 2017) the output gap was negative in 2016. According to the latest assessment made by the European Commission (assessment of the Stability Programme (SP) 2017) the output gap in Slovenia was also negative in 2016; however, it was assessed as the least negative compared to the assessments made by other institutions providing such assessments. The assessment, according to which GDP remains below the potential level of economic activity, is also confirmed by the calculations based on alternative methods of defining the cyclical situation of the economy. Even considering the historical revisions of estimates of the output gap, the latter would remain negative in 2016, although the assessment of the cyclical situation of the economy would come close towards balance in the case of upward correction[1]. Also the review of all available indicators indicates that the negative output gap was further reduced in 2016.

[1] Revisions in the output gap estimates for Slovenia are at the level of around ±1 percentage point (see for example IMAD: Economic Issues, 2016)

Figure 1: Estimate of output gap for 2016

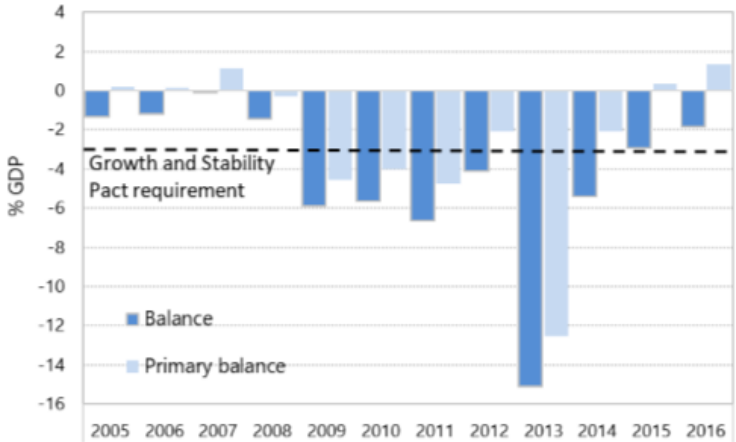


Note: The figure shows two averages. The "average of the institutions" contains estimates of the output gap made by the institutions. The "average of all estimates" includes, in addition to that estimate, also the estimates of the output gap based on statistical models (marked with *; the potential GDP is determined by the HP filter at various values of parameter λ (100,400,1600) and with a 5-year GDP average).
Sources: IMAD, Ministry of Finance, EC, IMF, OECD, Fiscal Council

2. Developments in public finance in 2016

Developments in public finance were favourable in 2016. They were mainly characterised by favourable macroeconomic conditions, a low rate of EU funds' absorption and a gradual relaxation of austerity measures. According to data from SORS the general government balance deficit amounted to EUR 733 million or 1.8% of GDP, while the primary balance surplus amounted to EUR 542 million or 1.4% of GDP in 2016. Such a deficit is below the anticipated target deficit in the Stability Programme (Amendment 2016) and the planned deficit in the Draft Budgetary Plan for 2016 (autumn, 2015), which in both documents amounted to 2.2% of GDP. 2016 was the second year in a row when the general government balance deficit was below 3% of GDP and the second year since Slovenia has exited the corrective arm of the Stability and Growth Pact. The primary balance showed a surplus for the second year in a row amounting to EUR 542 million or 1.4% of GDP. In comparison with the general government balance deficit this still indicates a large amount of interest expenditure, i.e. expenditure for debt financing.

Figure 2: Balance and general government primary balance



Source: SORS, calculations by the Fiscal Council

Only the central government subsector deficit dropped in 2016. A review of the general government sub-balances indicates that the lower central government deficit fully contributed to the general government deficit reduction. The local government sector generated a surplus which was, however, lower than in 2015, while social security funds recorded a lower deficit in 2016 after the surplus recorded in the past few years.

Table 3: Balance of the general government subsectors

	2013	2014	2015	2016
	EUR million			
Government	-5.426	-2.005	-1,126	-733
Central government	-5.439	-2.035	-1,292	-729
Local government	-51	-44	120	67
Social security funds	65	73	46	-70
	% GDP			
Government	-15,1	-5,4	-2,9	-1,8
Central government	-15,1	-5,4	-3,4	-1,8
Local government	-0,1	-0,1	0,3	0,2
Social security funds	0,2	0,2	0,1	-0,2

Source: SORS, calculations by the Fiscal Council

In comparison to 2015, general government revenues decreased by around EUR 80 million or by 0.5% in 2016. The fall in capital transfer revenues, which is mainly connected to a lower absorption of funds under the new financial perspective of the EU, contributed most to the drop in revenues. Revenue components that depend on macroeconomic developments grew steadily and in line with the favourable trends in the labour market and the increase in consumption, as tax revenue and social contributions increased by around 4% in comparison to 2015.

In comparison to 2015 the expenditure of the entire government sector decreased by around EUR 470 million or by 2.6% in 2016. Also in the case of a decline in expenditure, transactions related to the absorption of EU funds played the strongest role, as investments dropped most. Capital transfers that fell by around EUR 290 million were also lower year on year. Due to the high basis in 2015 [2] mostly smaller transfers related to the operations of the BAMC contributed to this situation. At the same time expenditure components representing the fixed part of expenditure increased significantly.[3] Among the expenditure components that increased the most the following stand out: compensation of employees because of the increase in the average wage and because of employment growth in the government sector, [4] while social benefits increased as the result of the partial relaxation of measures adopted in 2012. 5 Due to

[2] See also http://www.stat.si/StatWeb/News/Index/5898.

[3] Reviews of expenditure undertaken to date in several areas, such as in education, culture, social security and pension security, show the possibility of significant savings, also taking into consideration the provision of the achieved level of quality and appropriate coverage of needs in these areas.

[4] According to the data from the Register of Employment the number of employees in public administration and defence, and in compulsory social security, increased by 0.7% in 2016, in education it increased by 2.5% and in health care and social assistance it increased by 3.5%. According to the data submitted by the Ministry of Health (Report on the operations of public health care institutions and the Public Agency of the Republic of Slovenia for Medicinal Products and Medical Devices (JAZMP) in 2016) labour costs in hospitals increased by 7.6% in 2016 due to the relaxation of austerity measures and higher employment.

[5] Partially relaxed austerity measures taken in 2016 involved (i) an increase in the child benefit in the 5th and 6th income bracket, (ii) an increase in the amount of financial social assistance, (iii) a rise in the threshold for obtaining a state scholarship, income supplementary allowance and subsidies for school meals, and (iv) two extraordinary pension indexations.

the costs related to foreign exchange swap transactions of government bonds issued in the 2012-2014 period interest payments[6] also increased in 2016.

Table 4: General government revenues and expenditure

	2015	2016	Change (EUR million)	Year-on-year growth (%)
	mio EUR			
Revenues	17.433	17.352	-81	-0,5
Taxes	8.530	8.893	362	4,2
Social contributions	5.725	5.968	243	4,3
Capital transfers	741	36	-706	-95,2
Revenue from production	1.550	1.592	43	2,8
Other	886	863	-23	-2,6
memo: Revenue without capital transfers	16.691	17.317	626	3,8
Expenditure	18.559	18.085	-473	-2,6
Compensation of employees	4.313	4.587	273	6,3
Social benefits	7.020	7.142	123	1,7
Capital transfers	469	178	-291	-62,1
Intermediate consumption	2.567	2.601	34	1,3
Interest	1.263	1.275	12	0,9
Investments	1.827	1.213	-614	-33,6
Other	1.100	1.090	-9	-0,8
memo:				
Expenditure without investments	16.732	16.873	141	0,8
Expenditure without investments and capital transfers	16.262	16.695	433	2,7

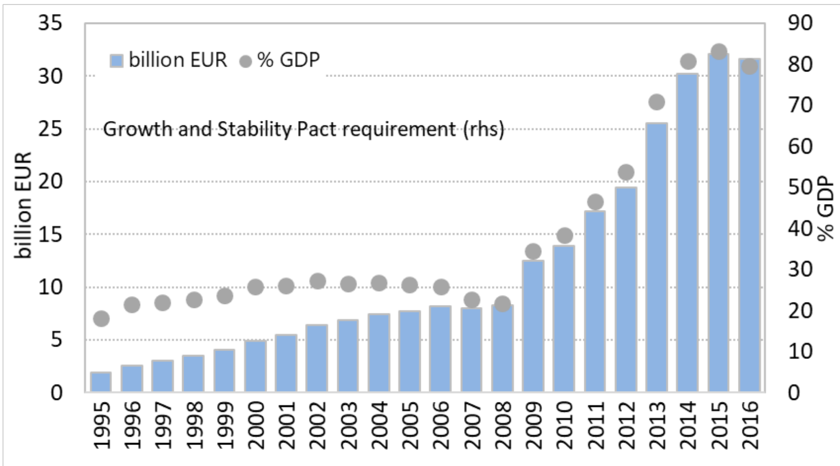
Source: SORS, calculations by the Fiscal Council

The general government debt dropped in 2016. After seven or eight years of ongoing increase, the debt dropped in nominal terms (by approximately EUR 400 million) as well as in relation to GDP (by 3.4 percentage points). By the end of 2016, the general government debt amounted to EUR 31.7 billion or 79.7% of GDP. This is less than the target debt predicted in the Stability Programme (Amendment 2016) and less than the debt planned in the Draft Budget Plan for 2016 (autumn, 2015), which amounted to 80.2% of GDP and 80.8% of GDP respectively. However, the debt still remains at a level exceeding 60% of GDP, which, inter alia, leads to increased requirements for structural adjustments of the fiscal policy. The reduction in debt in 2016 was mainly the result of the use of pre-financing funds from the preceding years, as the general government funds in the form of cash and deposits dropped by approximately EUR 1 billion. Ownership shares of the State also dropped by almost EUR 300 million and by a similar amount also the net loans taken. In 2016 the State increased its existing issuance and issued new long-term bonds in the total value of almost EUR 4.8 billion. Most of the newly issued debt in 2016 was

[6] In the 2012–2014 period Slovenia issued bonds in USD. Since it was exposed to foreign-exchange risks due to the issuance of bonds, it entered into foreign exchange swap transactions. Through these transactions dollar flows were converted into euros according to the agreed applicable exchange rate and the agreed interest rate. In accordance with the ESA 2010 methodology interest costs must be entered in the general government accounts so as to consider the current EUR/USD exchange rate on the day of interest payment and not the applicable exchange rate entered into through foreign exchange swap transactions. Foreign exchange swap transactions will therefore have an impact on the amount of interest until the bonds in USD are due. The last currently issued bond in USD will be due at the beginning of 2024. Read more about the impact of foreign exchange swap transactions on the general government balance on http://www.stat.si/StatWeb/News/Index/6630.

intended for the repayment of principals due (around EUR 3.6 billion). In favourable borrowing conditions on international financial markets bonds with a high expected bond yield issued in the 2012–2014 period continued to be exchanged for long-term bonds with more favourable financing conditions. Due to the high liquidity of the money market also the required yields of short-term debt instruments were low and since February 2016 they have amounted to less than 0%. The implicit interest rate of the overall debt decreased by 0.1 percentage point to 3.7% in 2016.

Figure 3: General government debt



Source: SORS, calculations by the Fiscal Council

Among the general government sub-sectors the major contribution to the decline in the general government debt in 2016 was made by the central government. It reduced the debt by approximately EUR 380 million. In other subsectors the debt remained mostly unchanged: at the local government level the debt dropped by approximately EUR 28 million, while the debt of social insurance funds dropped by approximately EUR 0.2 million. The prevailing share of general government debt has remained at the central government level (98% of the overall debt).

Table 5: Debt of general government subsectors

	2013	2014	2015	2016
		EUR billion		
General government in total	25,5	30,2	32,1	31,7
Central government level	25	29,6	31,5	31,1
Local government level	0,7	0,8	0,8	0,8
Social security funds	0	0	0	0
Consolidated debt between sub-sectors	-0,2	-0,2	-0,2	-0,2
		% GDP		
General government in total	71	80,9	83,1	79,7
Central government level	69,5	79,3	81,6	78,3
Local government level	2	2,1	2,	1,9
Social security funds	0,0	0,0	0,0	0,0
Consolidated debt between sub-sectors	-0,5	-0,5	-0,5	-0,5

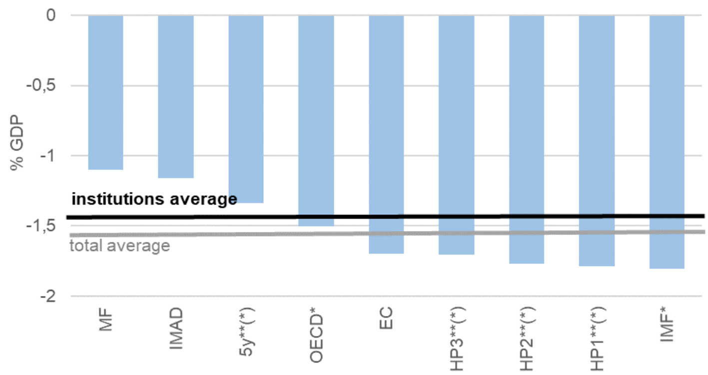
Source: SORS, calculations by the Fiscal Council

3. Compliance with the fiscal rules in 2016

In 2016 Slovenia complied with the fiscal rules that apply in periods in which the country has not yet achieved its medium-term fiscal target. Article 15 of the ZFisP stipulates that the general government budgets shall be deemed balanced in the medium term if the structural balance of the general government approaches the medium-term fiscal objective in accordance with the dynamics determined on the basis of the Stability and Growth Pact. In 2016 Slovenia also complied with the other two rules that apply in the preventive arm of the Stability and Growth Pact, i.e. the expenditure rule and the rule of gradual debt reduction.

The structural deficit continued to exist in 2016 and with regard to the estimates made by individual institutions it ranged between 1.1% and 1.8% of GDP. As a result, the medium term fiscal policy objective currently defined as structural surplus at a level of 0.25% of GDP was not achieved. It is obvious that the estimates of the structural deficit differ due to the varying assessments of the output gap. The average level of the recent estimates available on the structural deficit for Slovenia made by various institutions amounts to slightly below 1.5% of GDP.

Figure 4: Estimates of structural balance for 2016



Note: *IMF and OECD only publish estimates of the primary structural balance. For reasons of comparability these estimates were adjusted for interest payments. **The calculations use estimates of one-off effects from the SP16 and SP17.

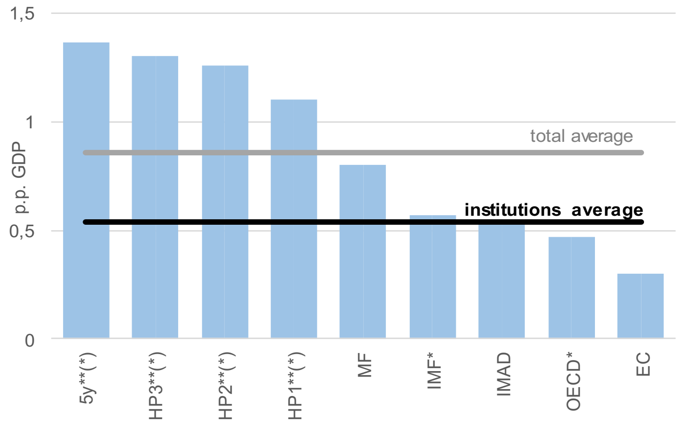
The figure shows two averages; the "average of the institutions" contains estimates of the structural balance prepared by the institutions, while the "average of all estimates" includes not only the average of institutions but also estimates of the structural balance based on statistical models (marked by *); the potential GDP is determined by the HP filter at different values of parameter λ (100,400,1600) and with a 5-year GDP average).

Sources: IMAD, Ministry of Finance, EC, IMF, OECD, Fiscal Council

The ***structural effort*** or the reduction of the structural deficit to be made by Slovenia according to the rules of the Stability and Growth Pact amounts to at least 0.6% of GDP. The amended flexibility rules in the Stability and Growth Pact determine – on the basis of a specific matrix – the required structural effort in countries that have not yet achieved their medium-term fiscal objective. According to this matrix and with regard to the presented estimates in this Assessment of compliance, in 2016 Slovenia ranked among the countries in which (i) the output gap ranged from -1.5% to 1.5% of GDP (being in the "normal" state of the economic cycle) and (ii) the general government debt exceeded 60% of GDP or is exposed to high risks with regard to debt sustainability.[7]

The structural effort reflecting a restrictive fiscal policy was reached in 2016. This is also evident from estimates of changes in the structural balance and the structural effort of all institutions preparing such estimates. Taking into account the available data the structural effort reached the value of 0.3 to 1.4 percentage points of GDP or expressed by differently defined averages from 0.5 to 0.9 percentage points of GDP. Under the conditions of a negative output gap with an increased structural effort the fiscal policy had a cyclically restrictive effect in 2016.

Figure 5: Compliance with the fiscal rules in 2016 (change in the structural balance)



Note: *IMF and OECD only publish estimates of the primary structural balance. For reasons of comparability these estimates were adjusted for interest payments and on the basis of having assessed the structural balance in this way, the change in the structural balance was calculated. **The calculations use estimates of one-off effects from the SP16 and SP17.
The figure shows two averages; the "average of the institutions" contains changes in the structural balance based on the estimates of the structural balance prepared by the institutions, while the "average of all estimates" includes not only the estimates of the institutions but also changes in the structural balance based on the estimates of the structural balance by means of statistical models (marked by *); the potential GDP is determined by using the HP filter at different values of parameter λ (100,400,1600) and with a 5-year GDP average).
Source: SORS, EC, IMAD, calculations by the Fiscal Council

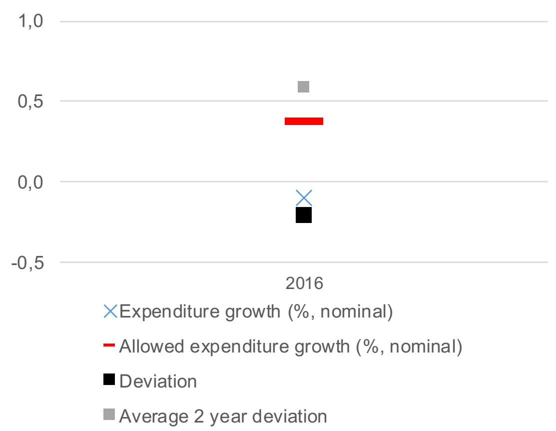
Slovenia also complied with the expenditure rule and the rule on gradual debt reduction in 2016. Although in the assessment of the compliance of a fiscal policy of the country in the preventive arm of the Stability and Growth Pact emphasis is placed on the achievement of the medium-term fiscal objective, public finance assessment also includes the expenditure rule and the level of the general government debt. Within the framework of the expenditure rule the calculation of appropriate expenditure growth excludes certain types of expenditures that cannot be directly influenced by the fiscal policy (for example interest payments, the cyclical component of unemployment benefits and expenditure resulting from the income from EU Funds). The rule also

[7] With regard to the nature of the Assessment of compliance of the general government budget with the fiscal rules in 2016 at this point the Fiscal Council does not deal with the issue of debt sustainability. The latter is designed for the long-term assessments and considers in particular expenditure related to the ageing of the population. Currently the estimate of debt sustainability has no impact on the classification of Slovenia in the matrix, because the condition under which the general government debt exceeds 60% of GDP has already been fulfilled.

takes into consideration that government investments vary considerably between years; therefore it considers a four-year average of investment expenditure that excludes received EU Funds earmarked for investment spending. The growth of expenditure determined in this manner must not exceed the growth of the potential GDP, while for countries not meeting the medium-term objective expenditure growth must be even lower or adjusted by the so-called "convergence margin" that provides compliance of the expenditure rule with the adjustment of the structural balance. Due to possible fluctuations, the estimate also considers the two-year average of growth of expenditure calculated by this methodology.

According to the **expenditure rule** the growth of expenditure excluding certain types of expenditure should have amounted to 0.4% in 2016, but, actually, expenditure dropped by 0.1%. Despite this finding the two-year average shows an insufficient decline in expenditure in 2016 to allow for the full correction of the positive deviation of expenditure growth in 2015.[8]

Figure 6: Compliance with the expenditure rule in 2016

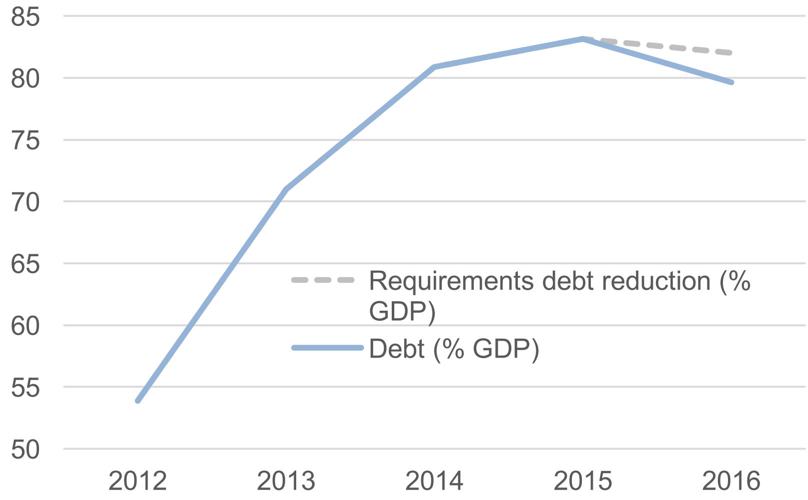


Note: This is not considered in the assessment of compliance with the fiscal rules (see note 8).
Source: SORS, SP2016, SP2017, calculations by the Fiscal Council

Pursuant to the rules of the Fiscal Pact in the transitional three-year period after the country has exited EDP (2016-2018) the **general government debt** must be reduced according to specific rules. The reduction must allow for structural adjustment in a way that ensures that after the expiry of the transitional period debt reduction rules can be achieved within the preventive arm of the Stability and Growth Pact. In the transitional period, the government must comply with the so-called minimum linear structural adjustment rule (MLSA) under which the general government debt in 2016 was allowed to amount to a maximum of 82.2% of GDP, but the share of the actual debt in GDP was 79.7%. After the termination of the transitional period the debt will need to be reduced by a 1/20 deviation of the debt level from the level of 60% of GDP. According to this rule, which will enter into force in 2019, the general government debt in 2016 should have dropped by 1.2 percentage points of GDP; however, its actual decline amounted to 3.4 percentage points of GDP. In this way, the required debt reduction in 2016 would be exceeded by almost three times.

[8] The two-year average indicator cannot be considered in the assessment of the compliance of the fiscal policy, because in 2015, which is considered in the calculation of the indicator for 2016, Slovenia was still under the excessive deficit procedure. Therefore, the two-year average related to the expenditure rule did not apply for Slovenia in 2016.

Figure 7: Debt reduction rule



Source: SORS, calculations by the Fiscal Council