REPUBLIC OF SLOVENIA
FISCAL COUNCIL

Assessment of compliance of the general government budgets with the fiscal rules in 2019

June 2019

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SUMMARY

Pursuant to the provisions of the Fiscal Rule Act, the Fiscal Council produced an assessment of compliance of the implemented budgets of the general government sector with the fiscal rules in 2019. According to the Fiscal Council's assessment, the budgetary policy was expansionary in 2019, although it should have been restrictive given the cyclical position of the economy. The expansionary policy largely derived from measures that did not promote long-term economic potential, but rather strengthened disposable household income.

Fiscal rules in 2019 were largely not complied with despite the relatively high revenue growth, which was mainly driven by favourable cyclical conditions. The minimum level of structural balance under the EU rules (MTO) in 2019 was not achieved. The national rule applying to the maximum permitted general government expenditure was not complied with, as the general government expenditure of the general government sector exceeded the level set in the adopted medium-term framework. All public finance budgets, except for the total expenditure of the municipalities, remained in line with the spending restrictions set by the framework for drawing up budgets. Compliance with the expenditure restrictions set by the framework is in principle a form of formal guidance for pursuing a countercyclical fiscal policy; compliance with this rule in 2019 would have resulted in a surplus of the general government sector balance twice as high than actually recorded. Growth in net expenditure under the EU rules exceeded the permitted level. Last year's decrease in the share of general government debt in GDP was appropriate.

Economic growth slowed to 2.4% last year, but given the still favourable position in the economic cycle, its nominal level and structure were encouraging general government revenue growth (4.8%). After a few years, general government revenue grew at a slower pace than expenditure (5.2%), which increased primarily due to economic policy measures, while the general government sector balance (0.5% of GDP) saw an almost half lower surplus than planned. The range of structural balance estimates indicates its deficit and a relatively unchanged situation compared to 2018, while the primary structural balance surplus, according to current estimates, decreased relative to the preceding year. In 2019, gross debt decreased both in nominal terms and as a share in GDP (to 66.1% of GDP).

The Fiscal Council assesses that also in 2019 the opportunity to create manoeuvring room for countercyclical fiscal policy action in less favourable macroeconomic conditions and appropriately strengthen general government debt sustainability was not fully seized. In addition to the expansionary economic policy, non-compliance with the fiscal rules also reflected the given institutional framework, which requires control over the entire general government expenditure. In 2019, the Government failed to implement measures to mitigate the expected adverse fiscal impacts of structural, especially demographic, pressures to which the economy will be exposed in the coming decades. On the contrary, some economic policy measures adopted in 2019 have even undermined medium- and long-term sustainability by reforming the pension system without taking measures to offset the additional burden on public finances.

Table1: Compliance with fiscal rules

	2019
Minimum structural balance under EU rules (MTO)	✘
EU expenditure rule	✘
Decline in general government gross debt	✓
National fiscal rule - maximum permitted expenditure of general government sector	✘

Source: SORS, MoF, FC estimates and calculations.

Legal framework

Pursuant to point 4 of paragraph two and point 3 of paragraph three of Article 7 of the Fiscal Rule Act (the ZFisP), the Fiscal Council is required to produce an assessment of compliance of the implemented budgets of the general government sector with the fiscal rules by 30 June of the current year for the previous year. On 31 March 2020, the Statistical Office of the Republic of Slovenia published the data on the *Main Aggregates of the General Government 2016–2019* according to the ESA methodology and on 17 April 2020 the *Excessive Deficit Procedure Report 2016–2019*. The Fiscal Council also obtained data from the consolidated public finance balance sheet from the Ministry of Finance compiled under the cash flow methodology.

In accordance with the ZFisP, in periods when approaching the medium-term budgetary objective, general government budgets are deemed balanced in the medium term if the structural balance of the general government sector approaches the minimum level of structural balance under the EU rules (MTO) in accordance with the pace determined in the Stability and Growth Pact (SGP). Pursuant to the SGP rules, the relevant MTO for Slovenia in 2019 is a structural surplus of 0.25% of GDP. After the MTO is achieved, the focus is shifted on assessing compliance with the national fiscal rules on the medium-term balance and general government expenditure in relation to the maximum levels set in the frameworks for drawing up budgets. In addition, in line with the ZFisP, the fiscal policy, regardless of MTO achievement, must ensure at least a balance over the medium term or on average over the economic cycle. In this assessment, the Fiscal Council verifies (i) the achievement of the medium-term budgetary objective under the SGP referred to in Article 15 of the ZFisP and (ii) compliance with the national fiscal rule referred to in Article 3 of the ZFisP.

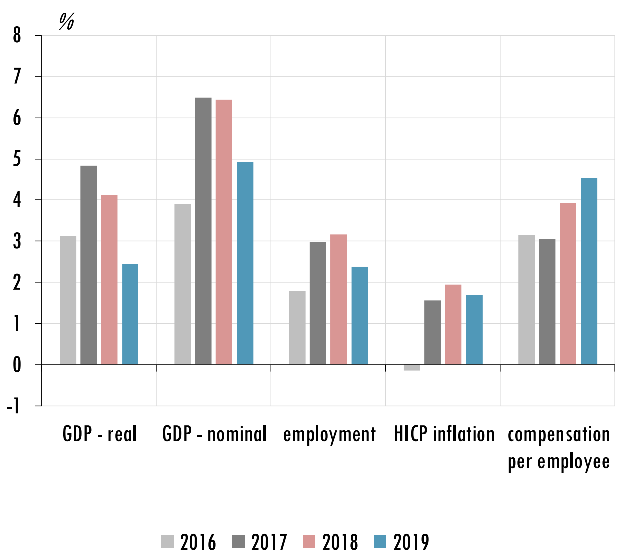
1. Macroeconomic and fiscal trends in 2019

1.1 The macroeconomic situation and assessment of the cyclical position of the economy

Economic growth slowed in 2019, but the growth structure continued to have a positive effect on the increase in tax bases. Real GDP grew by 2.4% last year, the lowest growth since 2015. The slowdown in nominal GDP growth (4.9%) was less pronounced. A key factor of economic growth was private consumption, which increased similarly to the previous year. Its growth stemmed from a slightly stronger growth in disposable income with further high growth in compensation of employees and higher growth in social transfers than in the preceding year. The slowdown in economic growth was largely a result of lower growth in foreign demand accompanied by greater uncertainty in the international environment. Export growth further slowed, but due to an even more pronounced slowdown in imports, the contribution of net exports to economic growth was slightly more positive than the year before. Investment growth slowed significantly, primarily due to a year-on-year decline in the last quarter of 2019, and contributed the most to the lower economic growth. Despite the slowdown of economic growth it had a positive effect on the general government revenue growth due to the dominant contribution of final consumption. The increase in compensation of employees (7.4%) was thus the same as in the previous year and the highest since 2008, which resulted from higher wage growth as employment growth was lower. Growth in the gross operating surplus slowed down further last year and was the lowest since 2012. Average inflation remained at a similar level as in the previous year as stronger domestic demand was accompanied by slightly lower commodity prices.

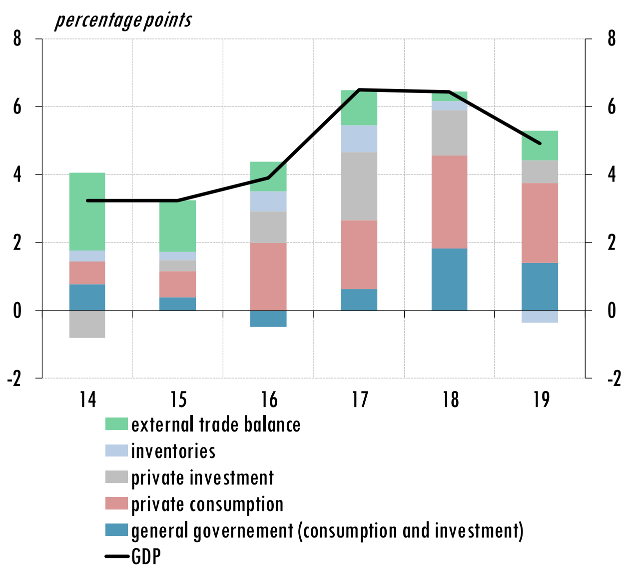
Based on various output gap estimates and particularly an overview of a broader set of indicators that determine the state of the economic cycle, the Fiscal Council estimates that the Slovenian economy saw no major macroeconomic imbalances in 2019. Output gap estimates differ due to different methodologies and differences in input data; furthermore (see Figure 1.3), they can significantly change over time or especially in the event of a major shock, as they are sensitive to major changes in economic growth forecasts. As the outbreak of the epidemic significantly worsened macroeconomic forecasts, the output gap estimates for previous years also changed, particularly for

Figure 1.1: Macroeconomic indicators



Sources: SORS, Eurostat.

Figure 1.2: Contributions to nominal GDP growth



Source: SORS, FC calculations.

Box 1.1: The cyclical position of the economy in 2019

The expected significant decline in economic activity this year and uncertainty about the recovery in the coming years make it difficult to assess the cyclical position of the economy, even for 2019. Output gap estimates are one of the important components in determining economic policy guidelines, as they are often revised due to several factors.[1] Most methodologies for calculating the potential output and the resulting output gap estimates take into account forecasts of future economic trends. Changed forecasts, especially if the changes are significant, therefore also affect the assessment of the cyclical position of the economy in the past. This is also why output gap estimates are subject to much criticism.[2]

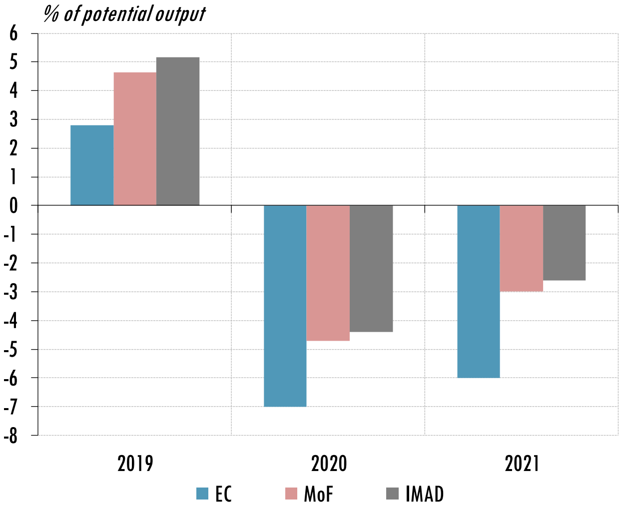
In addition to economic trend forecasts and the methodology used, many other factors influence the assessment of the level and growth of the long-term economic potential. These include data and methodology revisions, as well as the duration, type and consequences of shocks that have affected or will affect the economy in the current crisis. As current epidemic has been accompanied by a strong supply shock in addition to the demand shock, it could affect—especially with prolonged duration—changes in the response of production factors and the changed level and dynamics of the economy's potential. This impact largely depends on the flexibility of the economy and on the economic policy response.[3] According to some estimates, the current crisis could reduce the long-term economic potential by as much as half of the projected short-term negative impact.[4]

The long-term potential of the economy is very likely to diminish due to the current shock, while some production factors could change in such a way as to contribute to its increase in the future. Thus, despite the temporary reduction in employment, the pool of available workforce could remain unchanged due to government measures. The quality of the workforce would decrease with prolonged absence from work and especially with the increase in structural unemployment, but it could be improved through the greater use of modern technology in work processes, for example. Although a temporary decline in investment is expected, the resumption of both private and even more so public investment could increase the volume of capital, which could contribute to an enhanced long-term economic potential. Total factor productivity is likely to decline, inter alia, due to the need for higher taxes, a reversal in globalisation trends, the high share of small businesses, state aid that would allow businesses that would not otherwise be able to survive, and financial constraints or financial resources intended for less productive businesses.

Current output gap estimates for Slovenia differ considerably from previous estimates. The minimum point of the range of estimates from the set of output gaps monitored by the Fiscal Council is currently at the average level of the previous estimate from October 2019. The estimates of institutions using the same methodology to estimate the output gap also vary widely. The current output gap estimates based on the production function for 2019—prepared by the European Commission,[5] IMAD and the Ministry of Finance—are in the range of 2.8% to 5.2%. This is more than twice the range of the estimates for the period covered by the 2019 Stability Programme (2018–2022). The European Commission's output gap estimates for 2019 for Slovenia decreased by 0.2 percentage point relative to the previous estimate, which is the only decrease among the EU countries in addition to the estimate for Italy, whereas the estimate of EU average increased by 0.6 percentage point. The International Monetary Fund and the OECD did not publish output gap estimates when presenting their latest forecasts, which is not in line with the established practice and probably reflects the uncertainty of preparing such an estimate in the current situation. None of the institutions preparing output gap estimates for Slovenia have published a medium-term output gap estimate or potential output estimate, which makes it difficult to make output gap estimates in 2019 based on certain methodologies.

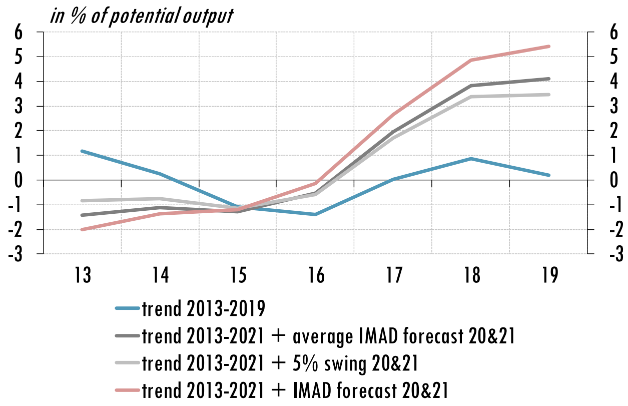
According to the Fiscal Council's analysis, the output gap estimate in Slovenia is significantly influenced by assumptions about the decline and the recovery of economic activity. A long-lasting slow recovery would result in structural and permanent changes in economic potential and would therefore lower potential output growth estimates also for past years, thus increasing the estimated positive value of the output gap for 2019. Taking into account different assumptions about the decline

Figure 1: Production function-based estimates of output gap for 2019-2021, assessed during preparation/assessment of Stability Programme 2020



Source: EC, MoF, IMAD.

Figure 2: Output gap estimates based on linear trend including various periods and using various assumptions regarding economic growth in 2020 and 2021

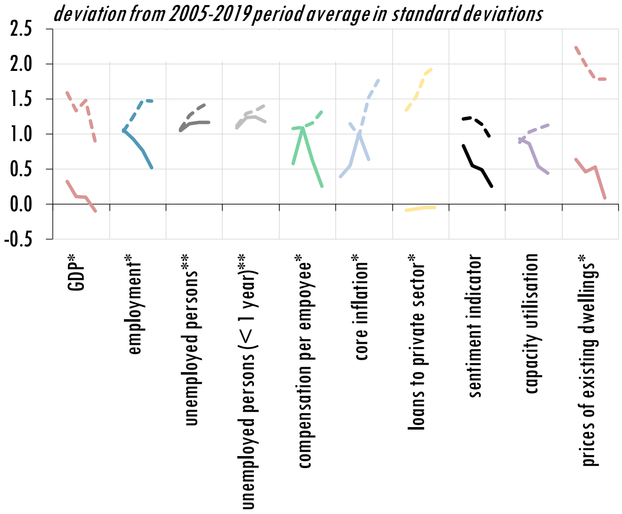


Note: The figure shows output gap estimates based on linear trend for 2013-2019 and 2013-2021 periods. Assumptions regarding 2020 in 2021 are (i) IMAD forecast, (ii) average dynamics of IMAD GDP forecasts, i.e. GDP declining 2,5% in both years and (iii) assumption of GDP declining 5% in 2020 and growing 5% in 2021.
Source: SORS, IMAD, FC calculations.

and recovery of economic activity in 2020 and 2021 would change the output gap estimate—herein determined on a simple linear trend method, which is neutral because it does not include any variables that could be revised significantly ex-post—by several percentage points. However, the output gap estimate could be changed even more by the length of the period for which the trend is estimated, particularly if the period of an expected economic shock (the blue line in Figure 2) is not taken into account.

The current uncertainties regarding future economic developments suggest the need for caution in interpreting output gap point estimates and the need to consider an additional set of indicators when assessing the cyclical position. This is the approach of the Fiscal Council since its inception. The indicators monitored to help determine the cyclical position deviated from the long-term average in 2019 by more than half less than the deviation seen in 2007 when the currently estimated positive output gap was around 7%. Labour market developments indicators deviated to a lesser extent, whereas lending dynamics indicators and real estate market indicators deviated more.

Figure 3: Indicators of economic cycle dynamics for 2007 and 2019



*Note: * y-o-y growth rates, ** inverted values. Data for 2007 are shown as dashed line, data for 2019 are shown as solid line.*
Sources: SORS, ECB, Eurostat, Employment Service of Slovenia, FC calculations.

[1] For an analysis of the variability of output gap estimates in Slovenia see e.g. the Report on the Fiscal Council's operation in 2017, available at http://www.fs-rs.si/wp-content/uploads/2018/05/Report-on-the-FC-operations-in-2017.pdf.

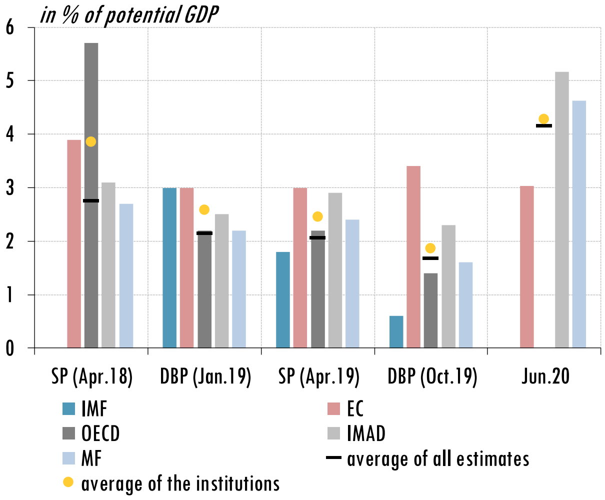
[2] E.g. Marcellino and Musso (The reliability of real-time estimates of the euro area output gap, Economic Modelling, 2011). Orphanides and van Norden (The Reliability of Output Gap Estimates in Real Time, Federal Reserve Board of Governors, 2002) further note that changes in output gap estimates are large, persistent, and especially stand out at business cycle reversals when the economic policy's error costs are the highest due to incorrect estimates of the cyclical position.

[3] European Commission (Impact of the current economic and financial crisis on potential output, European Economy Occasional Papers, 2009).

[4] Portes (VoxEu.org, June 2020).

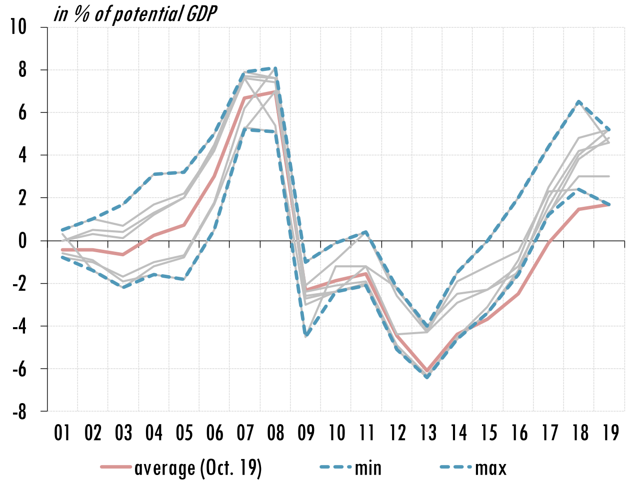
[5] The European Commission uses forecasts from the Stability Programme and a common production function methodology to calculate a comparable output gap estimate.

Figure 1.3: Output gap estimates for 2019 available at time of preparation of budget documents



Sources: EC, IMF, MoF, OECD, IMAD, FC calculations. Note: FC uses a wider set of output gap estimates since assessing SP2018. IMF and OECD have not yet published output gap estimates in 2020.

Figure 1.4: Output gap estimates



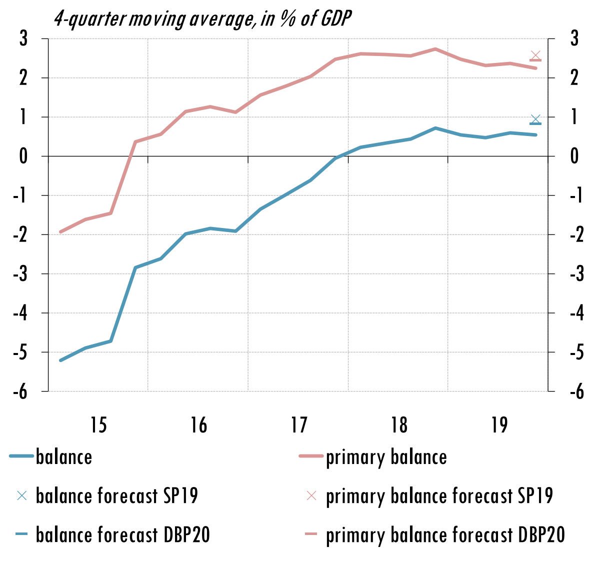
Sources: EC, IMF, MoF, OECD, IMAD, FC calculations. See note under Table 4.3 in Assessment of compliance of the Proposal of budgets of the Republic of Slovenia for 2020 and 2021 with the fiscal rules (http://www.fs-rs.si/wp-content/uploads/2019/10/Ocena-oktober-2019_koncna_ANG.pdf). IMF and OECD have not yet published output gap estimates in 2020.

2019 (see Box 1.1). In its assessments of budget documents, the Fiscal Council regularly draws attention to the precautionary principle (Article 4 of the ZFisP), which emphasises the need to take into account risks in public finance management. All currently available output gap estimates used by the Fiscal Council, which were prepared both before and after the outbreak of the epidemic, show that last year Slovenia's GDP level was above the potential output level. In view of the uncertainty and variability of output gap estimates, the Fiscal Council monitors a broader set of indicators in order to determine the state of the economic cycle. The values of indicators of economic activity, employment, sentiment, production capacity utilisation rate and prices of used real estate last year deviated from the highest in the period of economic recovery since early 2014. Last year, supply-side constraints intensified in the labour market, as indicated by the trend in the number of unemployed persons (total and short-term) and by wage trends, which was partly reflected in slightly stronger price pressures. It is estimated that supply constraints in the labour market are not only related to the cyclical position of the economy, but also to a significant extent to demographic changes.

1.2 Fiscal trends – the general government sector (ESA)

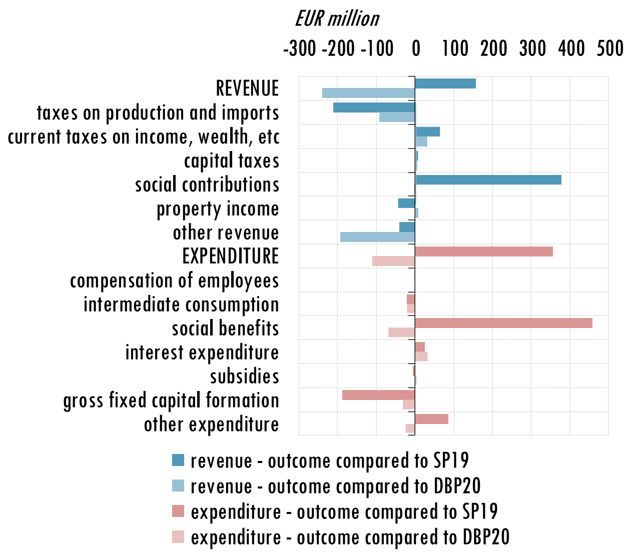
In 2019, the general government sector recorded a nominal surplus lower than the preceding year and lower than expected. The nominal surplus stood at 0.5% of GDP or EUR 260 million, down by 0.2% of GDP relative to 2018 and almost half less than planned in the 2019 Stability Programme. The lag behind projections was due to a more significant slowdown in economic growth than expected and the fiscal policy measures adopted, which partly reduced revenue and largely increased

Figure 1.5: General government balance and primary balance



Source: SORS, MoF forecasts: SP19 (Apr. 19) in DBP20 (Oct. 19); FC calculations.

Figure 1.6: 2019 outcome compared to SP19 in DBP20

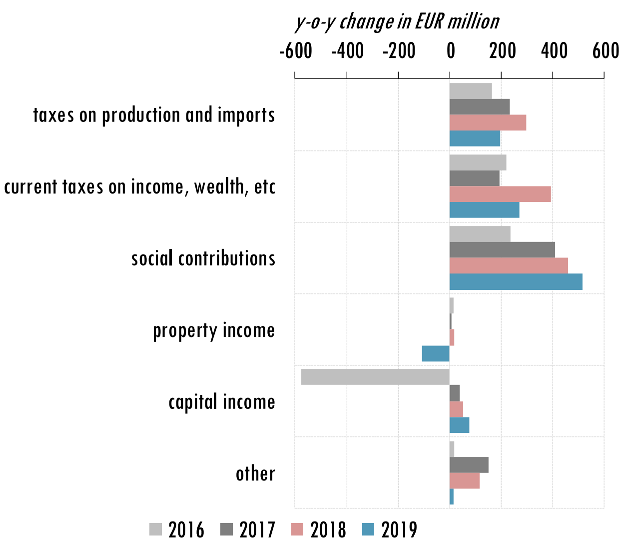


Source: SORS, MoF forecasts: SP19 (Apr. 19) in DBP20 (Oct. 19); FC calculations.

expenditure. The surplus primarily resulted from further improvement in the labour market situation and economic growth, which was still higher than the long-term average despite the slowdown. A review of the general government sub-balances indicates that the central government sector contributed the most to the general government balance surplus in 2019; this sector, however, recorded a smaller surplus than in the preceding year. The local government sector again showed a deficit, but slightly smaller than in 2018.

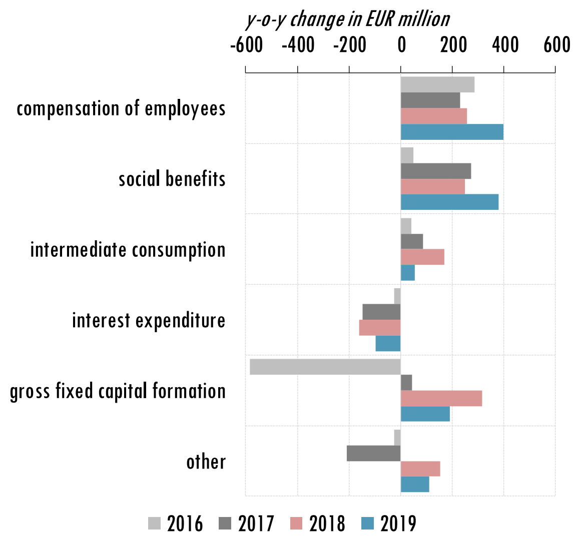
Revenue growth was slower than in the preceding year and lower than expenditure growth for the first time since 2013. The increase in revenue (4.8%) was a result of increased social contributions under continued favourable conditions in the labour market and growth in tax revenue, although the latter was significantly smaller than the year before. The latter was partly related to tax relief on holiday pay and the consequent lower increase in individual or household income taxes, and partly to

Figure 1.7: General government revenue



Source: SORS, FC calculations.

Figure 1.8: General government expenditure



Source: SORS, FC calculations.

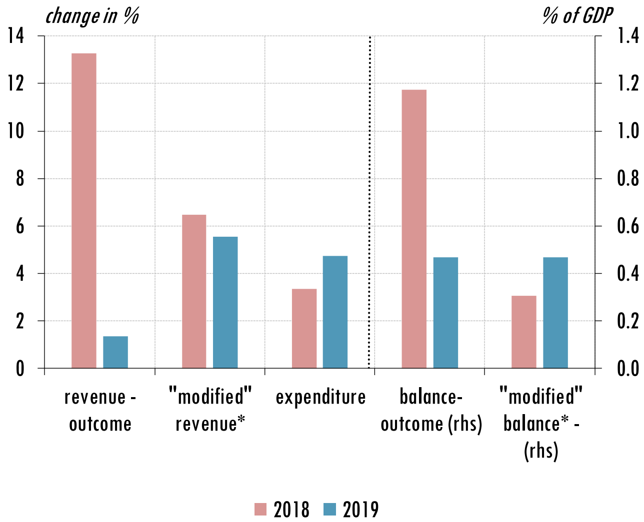
the lower growth of VAT revenue. The decrease in total property income in connection with lower dividend payments and the decrease in other current transfers also significantly contributed to the lower growth of total revenue compared to the previous year. The rise in revenue from taxes on income or profits of corporates and capital revenue remained high in 2019.

After a significant increase in 2018, expenditure growth (5.2%) was equally high in 2019, but the growth structure changed. Last year, the growth of employee compensation expenditure increased due to the wage increase agreement made with trade unions in December 2018 and due to the higher holiday pay as a result of the increase in the minimum wage and tax changes. Due to the easing and adoption of new measures, growth in the number of beneficiaries and extraordinary pension indexation and changes in the yearly bonus, growth in social transfer expenditure strengthened in 2019, reaching the highest level since 2009. Growth in other key expenditure categories slowed down last year. This especially applies to intermediate consumption expenditure, which otherwise recorded a quite high growth in 2018, and to investment expenditure, of which growth had halved. Interest expenditure further dropped significantly and thus continued to play an important role in achieving the general government sector surplus.

1.3 Fiscal trends – public finance budgets (cash-flow methodology)

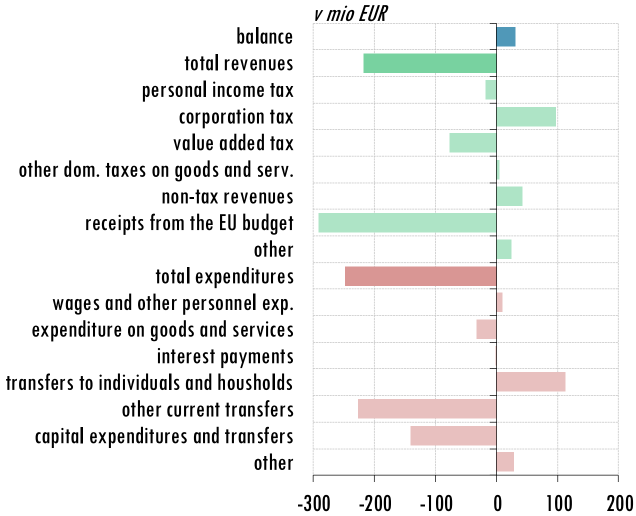
The state budget recorded a surplus of EUR 225 million (0.5% of GDP) in 2019, amid slowing revenue growth and higher expenditure growth than in the previous year. The surplus was slightly higher than planned in the revised state budget (by EUR 31 million), as expenditure lagged more behind the planned than revenue. Revenue growth slowed down significantly compared to the previous year, but the slowdown would have been much less pronounced if two one-off events had been eliminated, which contributed to higher revenue in 2018.[1] Revenue growth in 2019 stemmed primarily from higher corporate income tax revenue, coupled with higher settlements for 2018 as a result of

Figure 1.9: State budget



*Source: MoF, FC calcularions. Note: * Excluding two one-off events in 2018., see also footnote 1.*

Figure 1.10: Difference between outcome and revised state budget for 2019



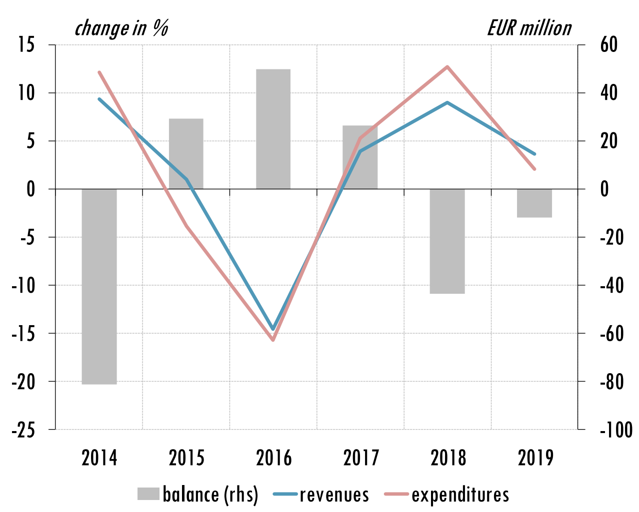
Source: MoF: state budget outcome and Revised budget of the Republic of Slovenia for 2019.

[1] The payment of outstanding EU funds under the previous financial perspective of EUR 207 million and NLB dividends of EUR 260 million, which was linked to retained earnings of the preceding year in the amount of EUR 189 million. If these two one-off factors were eliminated, revenue growth would have been 6.5% in 2018 (otherwise 13.3%) and 5.5% in 2019 (otherwise 1.4%).

companies achieving better business results than expected. The increase in VAT revenue was more than half lower than in the preceding year and lagged behind the planned in the revised state budget. Growth in personal income tax was about half lower than the year before, which was mainly related to tax relief on holiday pay. The slowdown in total revenue growth was also influenced by non-tax revenue, which was lower year-on-year, even excluding the base effect due to NLB's high dividend in 2018. The increase in European funds from the 2014–2020 perspective (28.4%) was almost three times lower than planned in the revised state budget. The Fiscal Council pointed out the overly optimistic planning of that aggregate when assessing the revised state budget.[2] Expenditure growth increased last year (from 3.4% in 2018 to 4.7%). This is predominantly due to the higher growth of overall labour costs[3] as a result of an agreement made with trade unions in December 2018 and expenditure on transfers to individuals and households due to the easing and adoption of new measures. The latter considerably exceeded the planned in the revised state budget, according to which they were expected to increase by 2.8% in 2019, whereas the actual increase was 11.5%. Among other expenditures, the increase in expenditure on goods and services and investment expenditure was much smaller than in the previous year and, together with subsidies, also lagged far behind the planned in the revised state budget. The lag of expenditure on investment and subsidies is mainly related to the lower absorption of EU funds than planned. Interest expenditure and transfers to social insurance funds held back total expenditure growth to a similar extent in 2019 as in the preceding year.

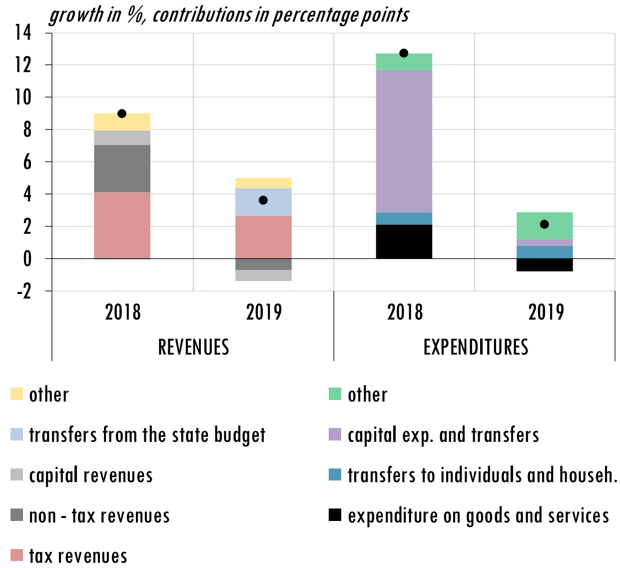
The municipal budget balance deficit (EUR 12 million) decreased in 2019 in the context of slower expenditure growth than revenue growth. Last year's slowdown in revenue growth (from 9.0% in 2018 to 3.6%) was primarily due to a decrease in non-tax revenue and revenue from the sale of buildings and premises and building land, which recorded high growth in the preceding year. Growth in personal income tax was also considerably lower than the year before, which was mainly related to legal changes. Thus, transfer revenue from the state budget and EU funds contributed the most to the growth of total revenue. The slowdown in expenditure growth (from 12.7% in 2018 to 2.1%) mainly

Figure 1.11: Budget balance of local government



Source: MoF, FC calcualtions.

Figure 1.12: Revenue and expenditure of local government



Source: MoF, FC calculations.

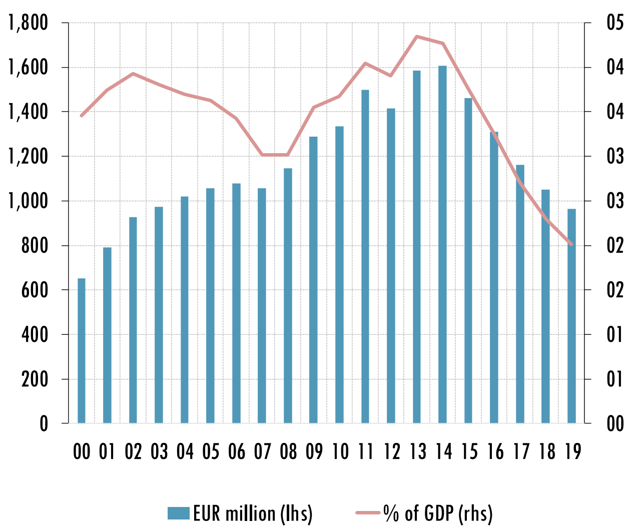
[2] For more information see the Fiscal Council's Assessment of compliance of the proposal of the revised state budget 2019 with the fiscal rules, p. 15 (February 20).

[3] In addition to expenditure on wages and social security contributions of employees, current transfers to public institutions for wages and social security contributions are included.

resulted from the almost complete halt in investment growth, which had risen by almost 30% in the preceding year and was probably related to the 2018 local elections. The slowdown in the growth of total expenditure was also a result of a decline in expenditure on goods and services, particularly maintenance expenditure. Total expenditure growth was thus predominantly the result of higher expenditure on transfers to individuals and households and current transfers to public institutions. With respect to the latter, the growth of funds for wages was much higher than in the previous year as a result of the agreement with the trade unions to raise wages.

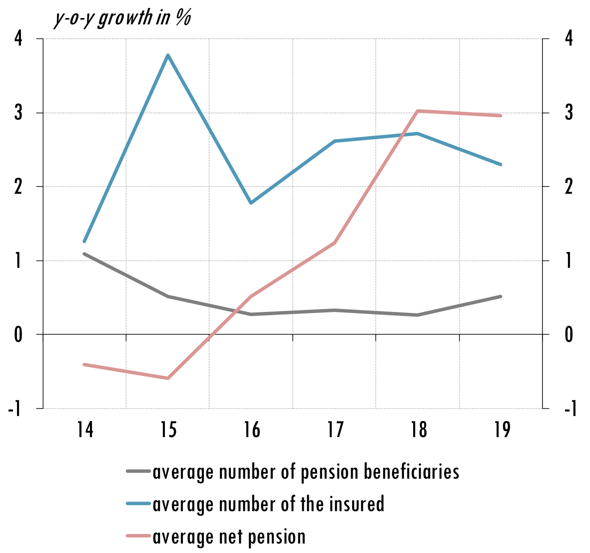
Last year's growth in revenue and expenditure of the Pension and Disability Insurance Institute of Slovenia (hereinafter: the pension insurance fund budget) was the highest since 2008. The increased growth in revenue of the pension insurance fund budget (4.1%) was mainly due to the favourable labour market situation and the associated higher revenue from social security contributions, which exceeded the expectations in the financial plan.[4] Funds from the state budget again decreased (by 8.1%) and amounted to EUR 965 million (2.0% of GDP), which is the lowest since 2002.[5] The reduction of transfers from the state budget was although again lower than in the previous year given that the rise in pensions triggered an increase in the expenditure of the pension insurance fund budget compared to 2018. The year-on-year increase in average old-age pensions was 3.0%[6] and the total amount of all pension payments increased by 3.8%, the highest growth since 2009. The growth in the number of pension recipients remained low (0.5%), thus the continued relatively high increase in the number of insured persons (2.7%) resulted in a higher ratio between insured persons and pension recipients, standing at 1.55.[7] Higher expenditure growth than in the preceding year was also a result of funds for the yearly bonus, which were paid in higher amounts and to more beneficiaries.

Figure 1.13: Pension Insurance Fund - state budget funding



Source: Pension and Disability Insurance Fund of Slovenia (ZPIZ), FC calculations.

Figure 1.14: Pensions



Source: Pension and Disability Insurance Fund of Slovenia (ZPIZ), FC calculations.

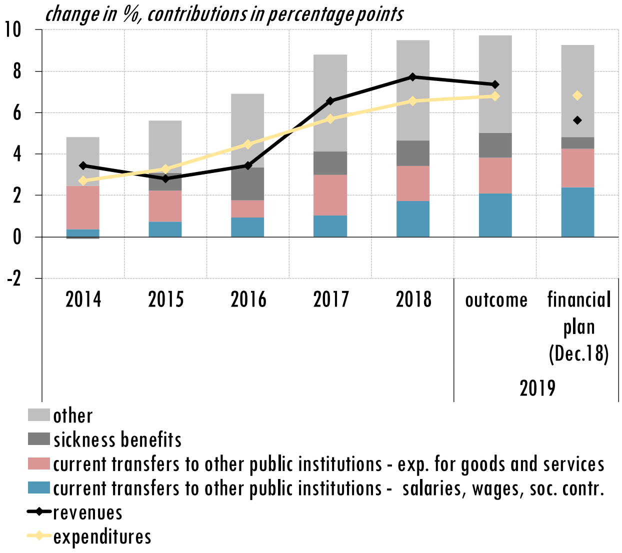
[4] The 2019 financial plan of the pension insurance fund budget was adopted on 20 December 2018; the revenue forecast was based on the 2018 autumn forecast by IMAD. The actual employee compensation growth in 2019 was higher than expected at that time, which contributed to EUR 38 million higher contributions than planned in the financial plan.

[5] Pursuant to Article 161 of the ZPIZ-2, certain types of pensions are funded from the state budget, which stood at 0.5% of GDP in 2019; pursuant to Article 162 of the ZPIZ-2, the Republic of Slovenia provides funds from the state budget and other sources to cover the differences between the revenue of the pension insurance fund budget from contributions and other sources and its expenditure, which stood at 1.4% of GDP in 2019. A small part of the funds received is represented by the employer's pension and disability contributions from parental and unemployment benefits.

[6] In accordance with the ZPIZ-2, the February pension indexation of 2.7% was made with effect from 1 January 2019; in accordance with paragraph two of Article 65 of the ZIPRS1819, an extraordinary indexation of pensions and other benefits by further 1.5% was made in December 2019.

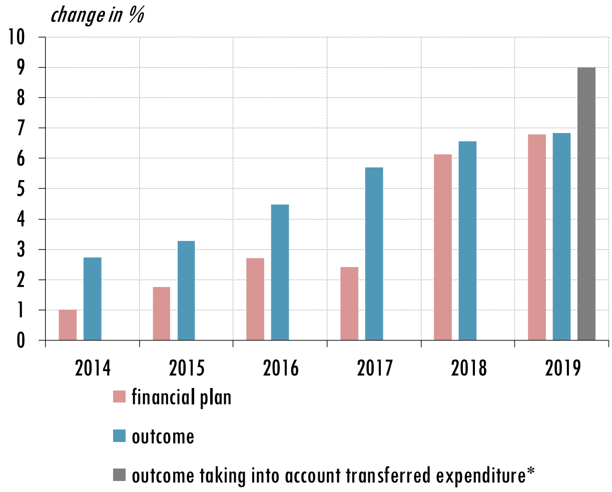
[7] The ratio was lowest in 2013 at 1.38.

Figure 1.15: The Health Insurance Fund revenues and expenditures



Sources: MoF, The Health Insurance Fund of Slovenia (ZZZS), FC calculations.

Figure 1.16: The Health Insurance Institute expenditures



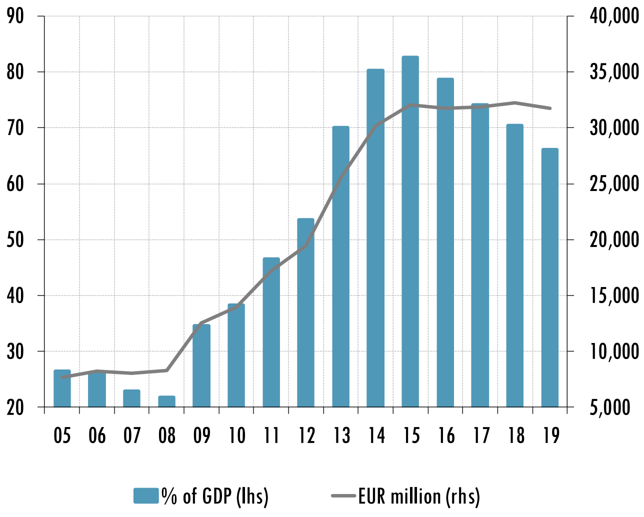
*Source: MoF, Health Insurance Institute of the Republic of Slovenia (ZZZS), FC calculations. Note: *Taking into account 63 million EUR which were transfered to 2020, but refer to 2019.*

The Health Insurance Institute of Slovenia (hereinafter: the health insurance fund budget) recorded a surplus in 2019, but transferred a significant part of its liabilities to this year. The health insurance fund budget recorded a surplus of EUR 51 million in 2019, but EUR 63 million of liabilities were transferred to this year in order to ensure compliance with the maximum level of expenditure set in the Framework for drawing up the general government sector budgets. Without the transfer of liabilities, the health insurance fund budget would have recorded a deficit of EUR 12 million. With last year's relatively high revenue and expenditure growth continuing, their share of GDP was the highest ever. Revenue growth (7.4%) exceeded expectations in the financial plan by EUR 50 million. As expected, the growth was mainly due to social contributions while the favourable conditions in the labour market continued. Total revenue growth also resulted from non-tax revenue and transfer revenue from other public financial institutions. As regards the latter, the increase in funds from the state budget was smaller than in the previous year with a decrease in current spending, but funds to cover expenditure on wages and compensation for interns, foundation doctors and specialty registrars increased further and more than expected. Expenditure growth (6.8%) slightly strengthened in 2019 and would have been as high as 9% if the transferred liabilities were taken into account. The strengthened overall growth was again due to higher growth in transfers to public institutions for labour costs as a result of the wage increase agreed with trade unions. The growth of transfers to public institutions for expenditure on goods and services and the growth of expenditure on sickness benefits were similarly high as in the preceding year, while expenditure on medicines grew more modestly.

1.4 General government debt

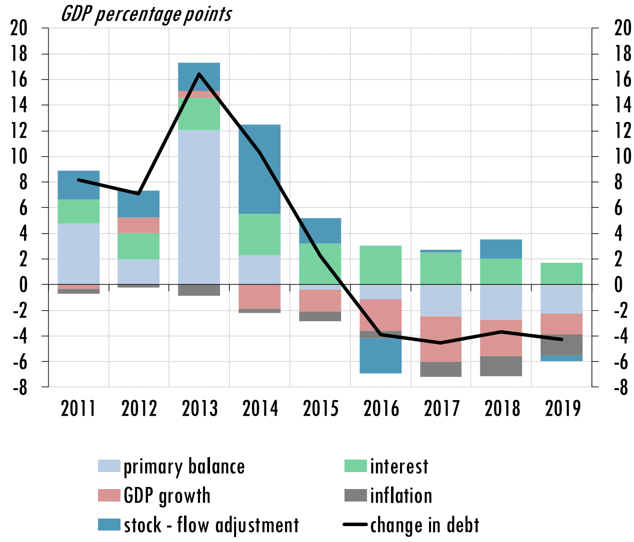
Gross general government debt fell to 66.1% of GDP (EUR 31.7 billion) in 2019 and was the lowest since the recovery of the banking system at the end of 2013. Debt fell both in nominal terms (by EUR 479 million) and as the share of GDP (by 4.3 percentage points of GDP). Due to their slowdown economic growth and the primary balance surplus contributed less to the reduction of debt than in the preceding year, but unlike in the preceding year the stock-flow adjustment also contributed

Figure 1.17: General government debt



Source: SORS.

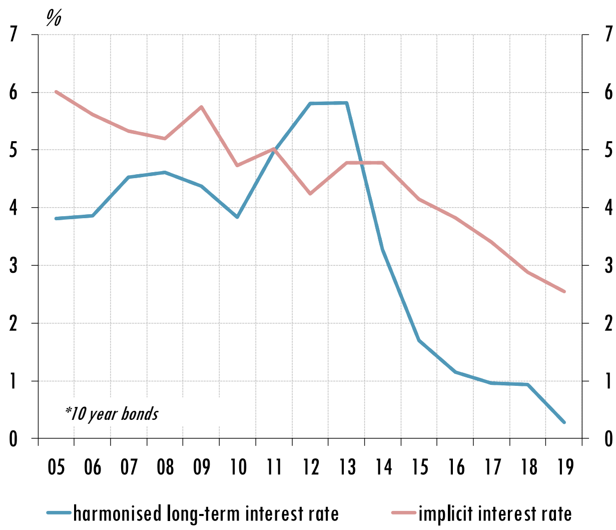
Figure 1.18: Change in general government debt



Source: SORS, FC calculations.

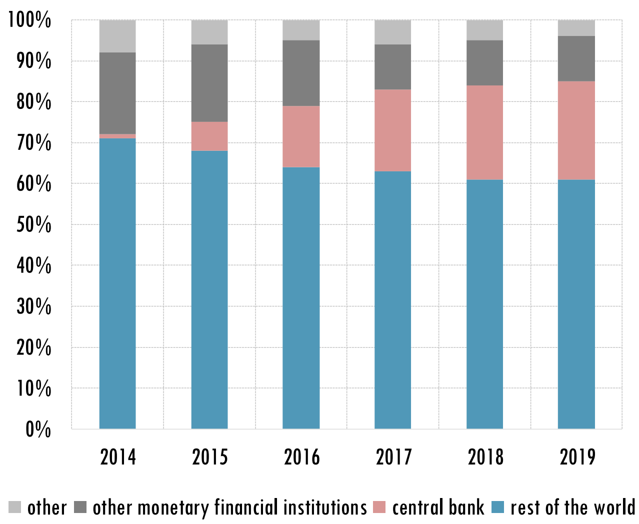
to the reduction in 2019. The decline in the debt-to-GDP ratio after 2015, when it reached its peak, was largest in the EU, but it is still much higher than before the financial crisis due to a significant increase in the first years of the crisis.[8] The volume of borrowing to fund the budget or pre-funding amounted to EUR 2.5 billion in 2019.[9] Borrowing continued last year in favourable financial market conditions, primarily due to the continuation of the ECB's expansionary monetary policy, while the central bank has become one of the major holders of government debt securities in recent years (see Figure 1.20). The required yield on the Slovenian 10-year bond decreased considerably (from 1.09% on average in 2018 to 0.40%), while the implicit interest rate on total debt declined by an additional 0.3 percentage point to 2.5%. The time distribution of liabilities remains favourable. The average

Figure 1.19: Harmonised long-term interest rate* and implicit public debt interest rate



Source: ECB, SORS, FC calcuations.

Figure 1.20: Structure of government debt securities holders



Source: BoS, FC calculations.

[8] Between 2008 and 2019, Slovenia experienced the fourth highest increase in the debt-to-GDP ratio in the EU (after Greece, Spain and Cyprus).

[9] The budget financing programme of the Republic of Slovenia for 2019 provided EUR 2.1 billion for the purpose of financing required for the implementation of the state budget in 2019.

weighted time to debt maturity (9 years) was slightly shorter than at the end of 2018 (9.2 years), but still longer than the OECD average (8 years).[10] After an increase in 2018, the amount of the general government's funds in the single treasury account decreased by EUR 2.5 billion and totalled EUR 4.0 billion or 8.6% of the GDP at the end of December.[11]

[10] OECD Sovereign borrowing outlook for OECD countries 2020, p. 13.

[11] More than half of the total decrease was due to a decrease in long-term deposits.

2. Compliance with the fiscal rules in 2019

In its assessment of compliance of the implemented budgets of the general government sector with the fiscal rules in 2019, the Fiscal Council verifies whether: (i) the minimum level of structural balance under the EU rules (MTO) and other requirements under the EU rules were achieved; (ii) the medium-term balance of public finance as defined by the ZFisP was ensured; and (iii) the implementation of the national fiscal rule defined in Article 3 of the ZFisP regarding the maximum permitted level of expenditure was respected. Due to the uncertainties related to the determination of the cyclical position for 2019, only the range of output gap estimates presented in Section 1.1. and Annex 3.2.—which is determined and applied by the Fiscal Council in each assessment of compliance with the fiscal rules—is used in assessing compliance with fiscal rules.

According to the Fiscal Council's assessment, the minimum level of structural balance under the EU rules (MTO) was not achieved in 2019. The first condition of medium-term balance in 2019 was thus not met. Furthermore, according to the currently available output gap estimates, it cannot be established beyond doubt that the economic cycle, as defined by the ZFisP, has ended. Ensuring a medium-term balance in the period after 2015, in which Slovenia exited the EDP and the ZFisP was adopted, would require a comprehensive annual structural effort. The national rule referring to general government expenditure was not complied with for the second year in a row in the past year. The total level of general government expenditure exceeded the maximum level permitted under the Framework, which, according to the Fiscal Council's assessment, was already set too high at the time of its adoption. Expenditure of individual public finance budgets calculated using the cash flow methodology were below the maximum permitted level of expenditure, with the exception of municipal budget expenditure. The growth of net general government expenditure exceeded the permitted growth under the SGP expenditure rule. The reduction in general government debt in 2019 was appropriate.

2.1. Achieving a minimum structural balance under the EU rules (MTO)

The Fiscal Council assesses that Slovenia did not achieve the minimum level of structural balance in 2019 according to EU rules (MTO). The MTO for Slovenia in the 2017–2019 period set under the EU rules[12] requires a structural surplus of at least 0.25% of GDP. The structural balance estimates may also diverge due to different output gap estimates.[13] The current structural balance estimates that were considered in the production of assessments of compliance of general government budgets with the fiscal rules range from –1.8% of GDP to –0.2% of GDP for 2019. The MTO in 2019 was thus not achieved even taking into account the permitted deviation of 0.25 percentage point of GDP.[14] In the case of the most favourable structural balance estimate, the criterion (0.5 percentage point of GDP) that represents a significant deviation from the MTO was also exceeded in 2019. The same applies to the average deviation over a period of two years, as it exceeded the permitted 0.25 percentage point of GDP according to current structural balance calculations.[15] The expansionary fiscal policy in 2019 was indicated by the development of the structural primary balance. The structural primary surplus was observed for the seventh year in a row last year, and compared to 2018 it did not change

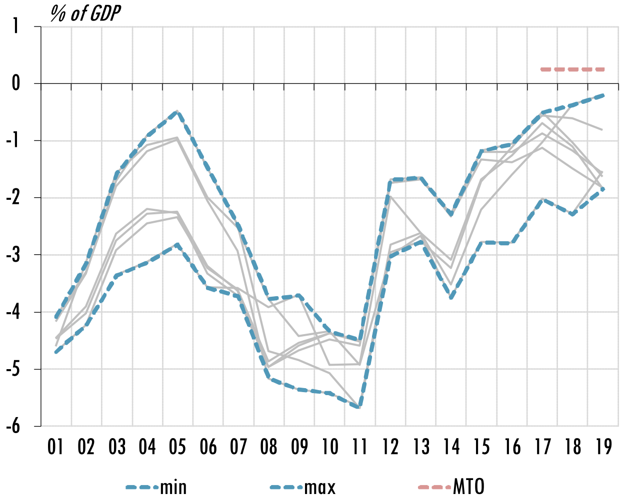
[12] Council Regulation (EC) No 1466/97.

[13] In producing its estimates, the Fiscal Council uses the estimates of five institutions and four statistical methods of output gap assessment. The Fiscal Council started to use the latter when it drew up its assessment of the 2018 Stability Programme. For more details on the output gap calculations used by the Fiscal Council, see the Report on the Fiscal Council's operations in 2017, pp. 23–26 (May 2018).

[14] The MTO would be achieved if the general government sector balance were equal to the one planned (0.8% of GDP) in the 2019 Stability Programme.

[15] For EU rules on deviations from the MTO, see Vade Mecum on the Stability and Growth Pact (European Commission, 2019: Chapter 1.3.7).

Figure 2.1: Structural balance estimates and MTO level



Source: EC, MoF, IMAD, FC calculations. See note under Table 4.3 in Assessment of compliance of the Proposal of budgets of the Republic of Slovenia for 2020 and 2021 with the fiscal rules (http://www.fs-rs.si/wp-content/uploads/2019/10/Ocena-oktober-2019_koncna_ANG.pdf). IMF and OECD have not yet published output gap estimates in 2020.

taking into account the most favourable output gap estimate in 2019; on average, however, it decreased by around half a percentage point of GDP, standing between –0.1% and 1.5% of GDP according to current estimates.

2.2. Compliance with the national fiscal rule – medium-term balance

In addition to achieving the medium-term budgetary objective, the medium-term balance under the SGP rules also implies that at least a balanced structural position is achieved over the entire economic cycle. Paragraph one of Article 3 of the ZFisP defines that the medium-term balance is achieved if the structural balance of the general government sector in an individual year is not lower than the minimum value as defined in the SGP while over the medium term it is at least in balance or in surplus. Point 5 of Article 2 of the ZFisP defines the medium term as a business cycle in which the actual level of GDP shifts from a level that is above the potential level of GDP to a level below and is on average equal to the potential level of GDP. (Indeed, vice versa also applies in economic terms: "the medium term" can also be defined as a business cycle in which the actual level of GDP shifts from a level that is below the potential level of GDP to a level above and on average equal to the potential level of GDP.)[16]

According to the Fiscal Council's assessment, the medium-term balance in 2019 was not reached. The Fiscal Council assesses that the minimum value of the MTO for 2019 set by the SGP was not achieved with the structural balance deficit in 2019 (see Section 2.1.). Thus, the first condition required under the definition of the medium-term balance was not met. In 2019, the medium-term (for different lengths of considered periods) average values of output gap estimates in the economic cycle concentrated near or slightly below 0. Based on this, it could be concluded that the economic cycle ended in 2019, but due to the uncertainties associated with current changes in output gap estimates this cannot

[16] For the purposes of economic analysis, both definitions indicate the period in which the sum of the output gap estimate deviations from the balanced position in the sequence of the indicated two phases of the economic cycle to the selected year amounts to 0. The IMF analysis (Aiyar and Voigts, 2019) points out that due to downward wage rigidity, the average output gap estimates in the economic cycle would generally be less than 0.

be unambiguously determined. In particular, as in previous assessments[17], the Fiscal Council notes that the period after the exit from the EDP or after the adoption of the ZFisP in 2015 through 2019 was too short to meet the medium-term balance, as extensive annual structural efforts would be needed during this period due to the high structural deficits accumulated in the previous crisis.[18]

2.3. Compliance with the national fiscal rule – maximum level of expenditure

The Framework relevant for the current assessment of compliance with the national fiscal rule, also referring to 2019 (the 2018–2020 period), was last amended in December 2018.[19] The Ordinance on a framework for drawing up budgets sets a maximum permitted level of general government sector expenditure[20] and a target balance, both of which determined in accordance with ESA methodology. The maximum level of expenditure and the target balance for the state budget, the health fund budget, the pension insurance fund budget and the municipal budgets are set according to the cash flow methodology. The Ordinance on the Framework related to 2019 was first adopted by the Slovenian Government in April 2016 and subsequently amended on six occasions, whereby the maximum permitted level of general government sector expenditure for 2019 was amended twice (in April 2017 and December 2018). Frequent changes of the Framework distort the medium-term budgetary planning purpose, as compliance with the Framework is in principle a formal guidance for conducting countercyclical fiscal policy. The Fiscal Council also drew attention to this during the last amendment to the Framework (relating to 2019) in December 2018, when the changes referred only to 2019. In addition, according to the Fiscal Council's assessment at that time, the maximum level of general government sector expenditure for 2019 under the Framework amended in December 2018 exceeded the level permitted by the then assessed cyclical position of the economy in accordance with the ZFisP.[21] Nevertheless, the projected expenditure in the 2019 Stability Programme adopted in April 2019 further exceeded the maximum level of expenditure set in the Framework.[22]

In 2019, general government sector expenditure exceeded the maximum level permitted under the applicable Framework for drawing up budgets. In 2019, general government sector expenditure was EUR 357 million above the level permitted in the applicable Framework for 2019 as set in December 2018, while revenue was even higher than expected when the amendment to the Framework was drawn up. Thus, the general government sector surplus of 0.5% GDP was slightly higher than the target surplus of 0.4% of GDP set in the Framework; taking into account the maximum general government sector expenditure set in the Framework and the actual realised revenue, the general govern-

[17] See the Assessment of compliance of the general government budgets with the fiscal rules in 2018 (Section 2.2.), available at: http://www.fs-rs.si/wp-content/uploads/2019/06/Assessment_Expost2018.pdf

[18] The Fiscal Council's calculations show that in 2016–2019, following the adoption of the ZFisP or after Slovenia's exit from the EDP in 2015, an annual structural effort of around 3.5 percentage points of GDP would be required in order to achieve the medium-term balance in 2019, according to current estimates of the cyclical position of the economy. Based on various output gap indicators and at different lengths of the economic cycle, the average sum of structural balances in 2019 indicates a cumulative structural deficit at around 14 percentage points of GDP.

[19] http://www.pisrs.si/Pis.web/pregledPredpisa?id=ODLO1956 – only in Slovene

[20] The maximum level of expenditure is calculated in accordance with the mathematical formula set out in points 3 and 4 of Article 3 of the ZFisP depending on the position of the economy in the economic cycle. For this assessment of compliance with the fiscal rules in the preceding year, the formula that applies when the actual GDP is above the potential level was used (paragraph four of Article 3 of the ZFisP). In such a case, the maximum level of expenditure is determined by deducting the projected level of potential GDP multiplied by the factor corresponding to the state of the economy in the business cycle from the projected scope of general government revenue. Temporary or one-off expenditures are not taken into account.

[21] Assessment by the Fiscal Council: Proposal for the Ordinance amending the Ordinance on the Framework for Preparing General Government Budgets for the Period 2018–2020 (http://www.fs-rs.si/wp-content/uploads/2018/12/Assessment_-December_2018.pdf).

[22] Assessment of compliance of fiscal policy with the fiscal rules on the basis of the draft Stability Programme 2019 and the proposed Ordinance on the framework for the preparation of the general government budgets for the 2020-2022 period (http://www.fs-rs.si/wp-content/uploads/2019/04/Assessment_SP2019.pdf)

Table 2.1: Deviation of general government expenditure from maximum level set in the Framework relevant for the current assessment for 2019

2019 (EUR million)	general government *ESA 2010*	state budget *GFS*	local government *GFS*	pension fund (ZPIZ) *GFS*	health fund (ZZZS) *GFS*
Framework (Dec.18)	20.610	10.160	2.235	5.530	3.055
outcome	20.967	9.912	2.244	5.510	3.053
difference	357	-248	9	-20	-2

Source: Official Gazette of the Republic of Slovenia (UL), MoF, FC calculations.

ment sector surplus would be 1.3% of GDP in 2019. Thus, in strict compliance with the ZFisP, a counter-cyclical fiscal policy would be pursued and greater room for manoeuvre would be given to the fiscal policy to deal with the current crisis. The state budget expenditure and expenditure of the pension and of the health insurance fund budgets were lower than the maximum level permitted in the Framework of December 2018, while the total expenditure of municipalities was slightly higher. The sum of expenditure of the abovementioned four budgets was below the maximum permitted level set for these four budgets. In part, these differences can be attributed to methodological differences[23] and in part they result from revenue and expenditure trends in the general government sector units not under the direct supervision of the Ministry of Finance or the Government.

2.4. Compliance with the EU expenditure rule

The growth of expenditure in 2019 exceeded the maximum limit set by the EU expenditure rule. Within the framework of the EU expenditure rule, the calculation of appropriate expenditure growth excludes certain types of expenditure that cannot be directly influenced by the fiscal policy.[24] Such expenditure includes interest payments, the cyclical component of unemployment benefits and expenditure linked to receipts from EU funds. The rule also takes into consideration that government investments vary considerably from year to year, therefore the assessment of compliance with the expenditure rule takes into account the four-year average of investment expenditure, excluding received EU funds earmarked for investment spending. The growth of such expenditure should not exceed the average 10-year growth of the potential product.[25] For countries not meeting the MTO, expenditure growth must be even lower and adjusted by a convergence margin that ensures the expenditure rule is harmonised with the required adjustment of the structural balance. Due to possible annual fluctuations, the estimate also considers the two-year average of the growth of expenditure determined in this manner. In addition, an expenditure growth estimate is made with deducted one-off effects that influence the general government expenditure and revenue. When determining the permitted expenditure growth in a particular year under the SGP expenditure rule, the assumptions available in the spring of the previous year are applied, thus ensuring greater stability of estimates regarding the fiscal policy's

[23] The general government sector includes a broader range of institutional units than only four public finance budgets, as presented at http://mf.arhiv-spletisc.gov.si/si/delovna_podrocja/javne_finance/tekoca_gibanja_v_javnih_financah/sektor_drzava/#lg=1&slide=0. The list of institutions classified into the general government sector in Slovenia is available at https://ec.europa.eu/eurostat/documents/1015035/7110762/SI-EDPI-Annex-I-201512.xlsx. In addition, developments in the general government sector are monitored on the basis of the methodology of the European system of accounts (ESA 2010) and the public finance budgets on the basis of the International Monetary Fund's methodology for monitoring the Government Finance Statistics (GFS).

[24] For more information about the expenditure rule, see Vade Mecum on the Stability and Growth Pact 2019, pp. 27–32 (March 2019).

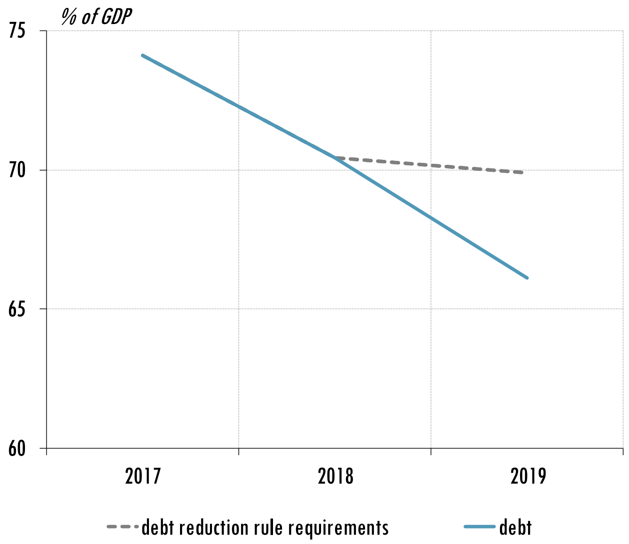
[25] In accordance with the rule, the 10-year average is taken into account, i.e. five preceding years, the current year and the following four years. The Fiscal Council uses the potential growth calculations prepared by IMAD for each forecast. In its latest forecast of economic trends (the COVID-19 scenario from May 2020), IMAD did not prepare medium-term forecasts of potential growth. Therefore, the Fiscal Council used the latest available forecasts in calculating the 10-year average.

effectiveness. To determine the allowed growth in 2019, data known in the spring of 2018 were used. According to these data, a structural effort of 0.65% of GDP was required due to the assessment of structural balance deviation in 2018 from the MTO for 2019. The actual growth of net expenditure without taking into account one-off effects stood at 5.1% and exceeded the allowed growth rate (3.5%), which the Fiscal Council pointed out when assessing the 2019 Stability Programme[26] and during the process of adopting state budgets last autumn[27]. Expenditure also exceeded the allowed growth in an average of two years.

2.5. Compliance with the general government debt rule

Slovenia complied with the Fiscal Pact's rule on gradual debt reduction in 2019. Within three years of Slovenia's exit from the EDP, specific principles applied to determining this rule. In Slovenia's case, the three-year transitional period covered 2016–2018, as the general government sector deficit fell below 3% of GDP in 2015. From 2019 inclusive, Slovenia is required to reduce general government debt following the yearly dynamics that in a three-year average corresponds to a 1/20 deviation in the debt level from the base-year level of 60% of GDP. At the end of 2018, general government debt was 70.4% of GDP, thus exceeding the 60% of GDP level. According to the aforementioned rule, it should decrease by at least 0.5 percentage point of GDP in 2019. By reducing general government debt by 4.3 percentage points of GDP in 2019, this rule was adhered to.

Figure 2.2: Debt reduction rule



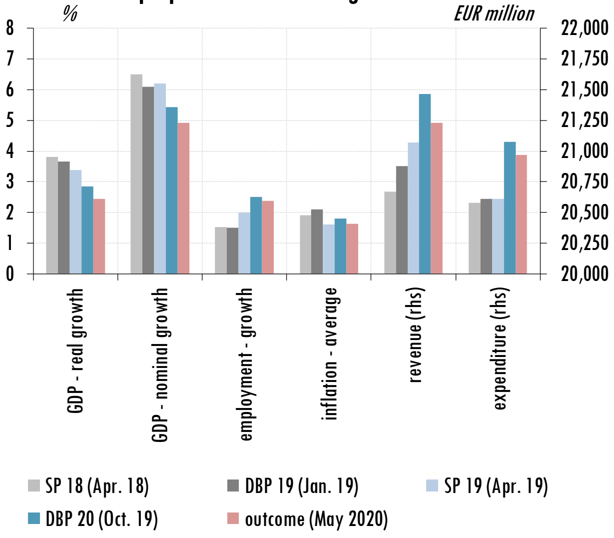
Source: MoF, SORS, FC calculations.

[26] Assessment of compliance of fiscal policy with the fiscal rules on the basis of the draft Stability Programme 2019 and the proposed Ordinance on the framework for the preparation of the general government budgets for the 2020-2022 period (http://www.fs-rs.si/wp-content/uploads/2019/04/Assessment_SP2019.pdf)

[27] Assessment of compliance of the Proposal of budgets of the Republic of Slovenia for 2020 and 2021 with the fiscal rules (http://www.fs-rs.si/wp-content/uploads/2019/10/Ocena-oktober-2019_koncna_ANG.pdf)

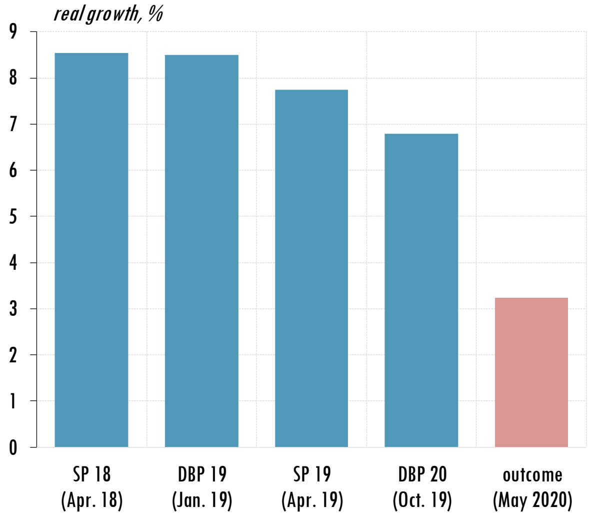
Annex 3.1: Changes in the macroeconomic and fiscal projections for 2019

Figure 3.1: Forecasts for 2019 available at the time of preparation of the budget documents



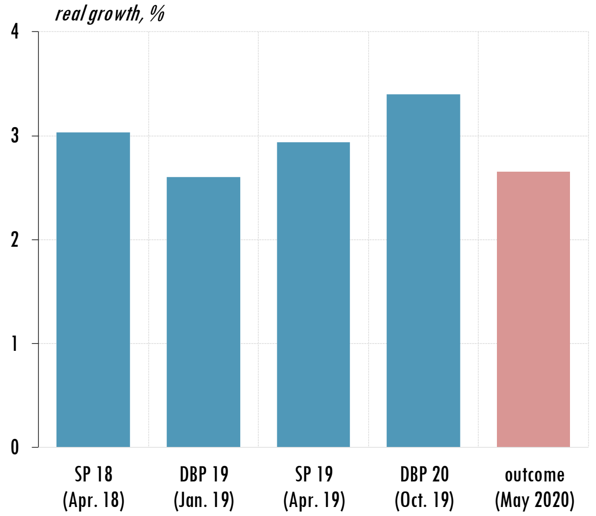
Source: forecasts IMAD, MoF; outcome SORS.

Figure 3.2: Changes in the 2019 forecast - gross fixed capital formation



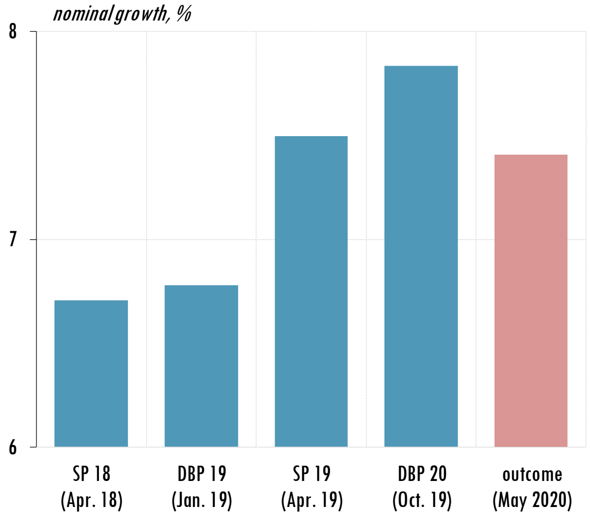
Source: SORS, forecasts IMAD.

Figure 3.3: Changes in the 2019 forecast - private consumption



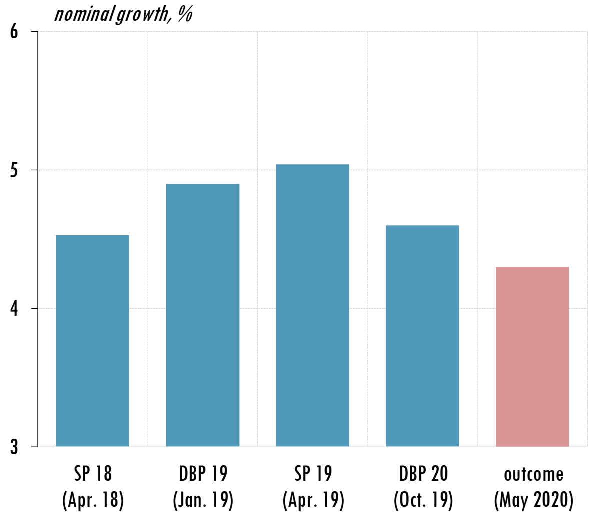
Source: SORS, forecasts IMAD.

Figure 3.4: Changes in the 2019 forecast - compensation of employees



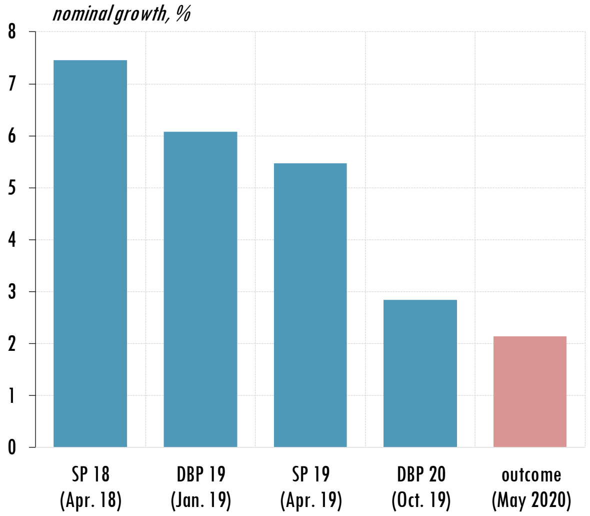
Source: SORS, forecasts IMAD.

Figure 3.5: Changes in the 2019 forecast - gross wages per employee



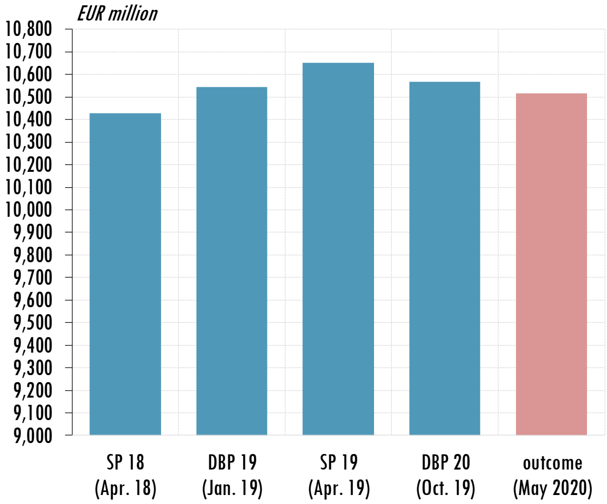
Source: SORS, forecasts IMAD.

Figure 3.6: Changes in the 2019 forecast - gross operating surplus/mixed income



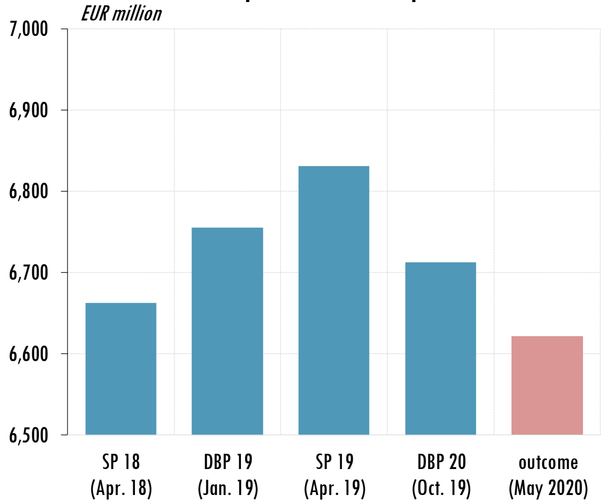
Source: SORS, forecasts IMAD.

Figure 3.7: Changes in the 2019 forecast - total taxes



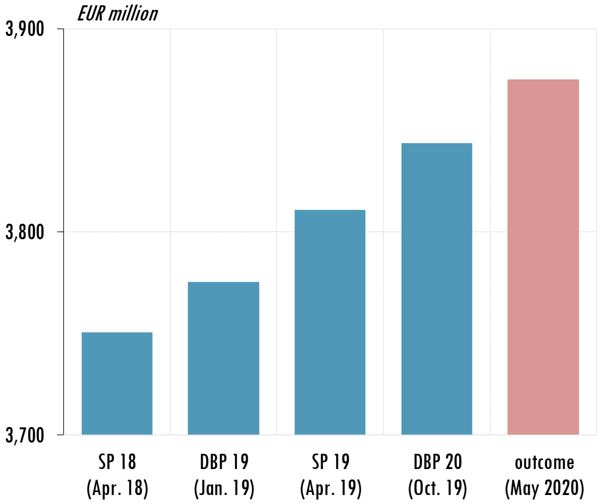
Source: SORS, forecasts MoF.

Figure 3.8: Changes in the 2019 forecast - taxes on production and imports



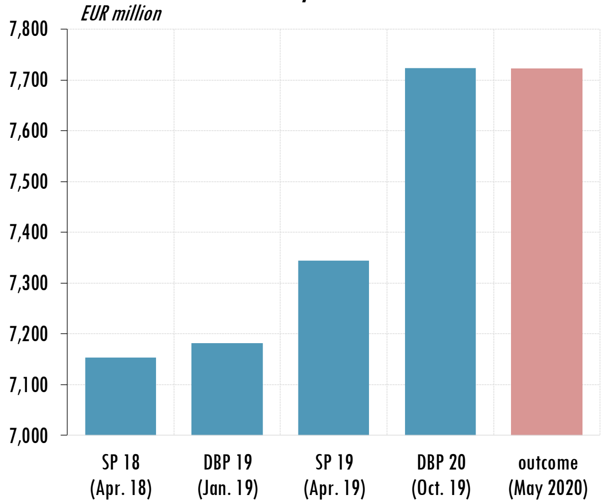
Source: SORS, forecasts MoF.

Figure 3.9: Changes in the 2019 forecast - current taxes on income and wealth



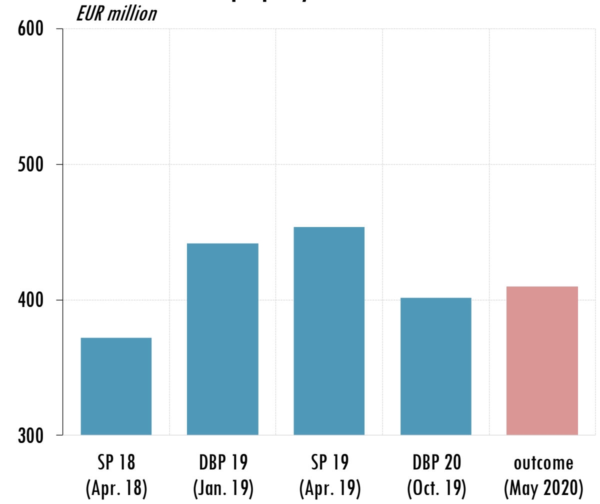
Source: SORS, forecasts MoF.

Figure 3.10: Changes in the 2019 forecast - social security contributions



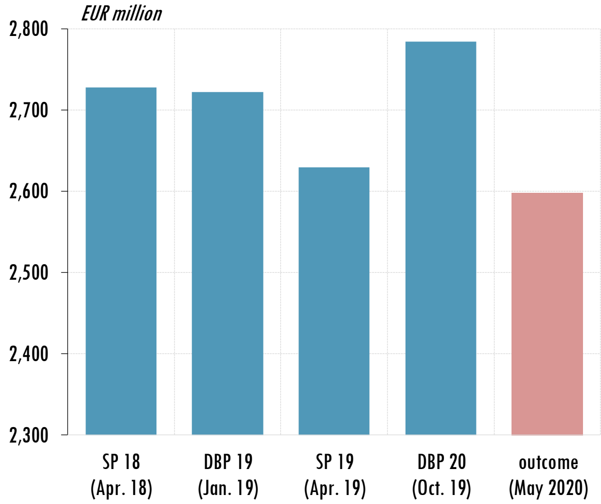
Source: SORS, forecasts MoF.

Figure 3.11: Changes in the 2019 forecast - property income



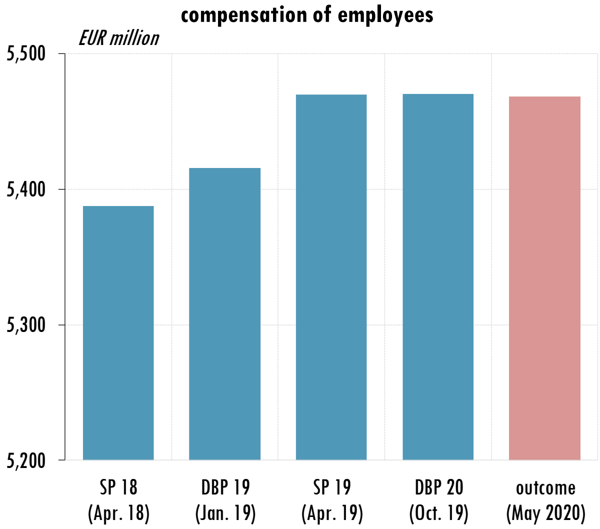
Source: SORS, forecasts MoF.

Figure 3.12: Changes in the 2019 forecast - other revenue



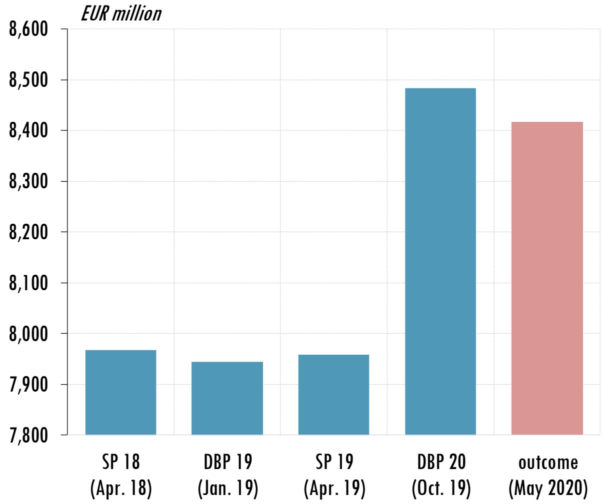
Source: SORS, forecasts MoF.

Figure 3.13: Changes in the 2019 forecast - compensation of employees



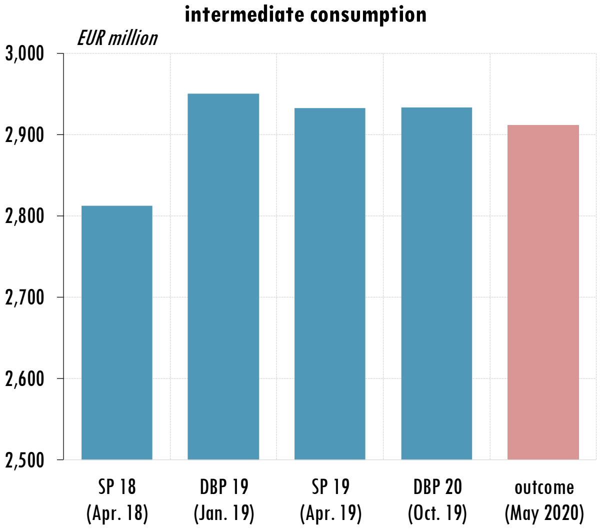
Source: SORS, forecasts MoF .

Figure 3.14: Changes in the 2019 forecast - social benefits



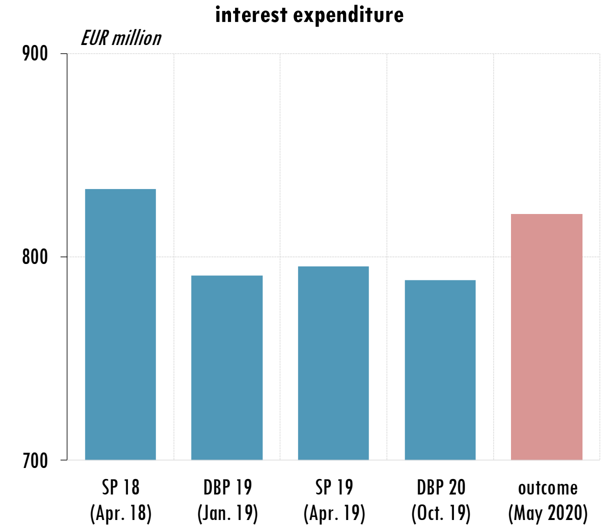
Source: SORS, forecasts MoF.

Figure 3.15: Changes in the 2019 forecast - intermediate consumption



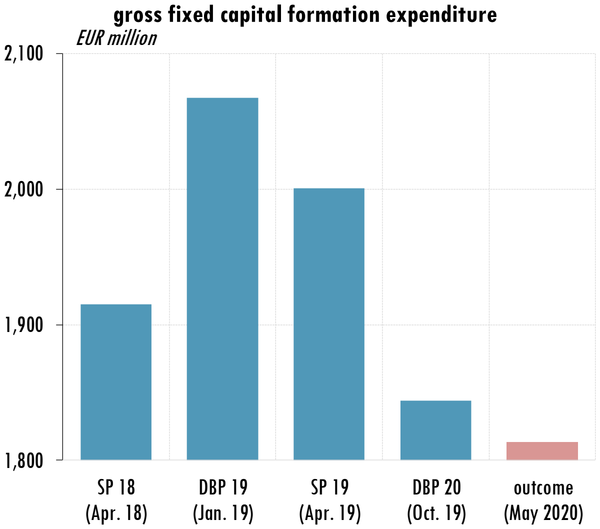
Source: SORS, forecasts MoF.

Figure 3.16: Changes in the 2019 forecast - interest expenditure



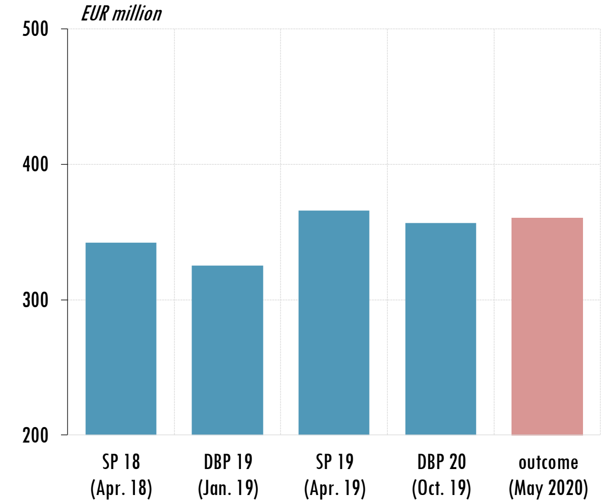
Source: SORS, forecasts MoF.

Figure 3.17: Changes in the 2019 forecast - gross fixed capital formation expenditure



Source: SORS, forecasts MoF.

Figure 3.18: Changes in the 2019 forecast - subsidies



Source: SORS, forecasts MoF.

Annex 3.2: Output gap and structural balance estimates for 2019

Table 3.1: General government structural balance according to various output gap estimates

2019	Blanchard Quah (Jun. 20)	Factor models (Jun. 20)	HP (Jun. 20)	Long-term average (Jun. 20)	EC (May 20)	IMAD (Apr. 20)	MoF (Apr. 20)	average EC, MoF, IMAD*	**average total**	min	max	MTO
Output gap	4.6	1.7	5.2	4.8	3.0	5.2	4.6	4.3	**4.2**	1.7	5.2	-
Structural balance	-1.5	-0.2	-1.8	-1.6	-0.8	-1.8	-1.6	-1.4	**-1.4**	-1.8	-0.2	0.25

*Note: * institutions that calculate output gap on the basis of commonly agreed methodology according to SGP.*
Sources: IMAD, EC, MoF, FC calculations. IMF and OECD have not yet published output gap estimates in 2020.