REPUBLIC OF SLOVENIA
FISCAL COUNCIL

Fulfilment of conditions for the existence of exceptional circumstances in 2022

September 2021

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Data avilable up to and including 22 September 2021 were used.

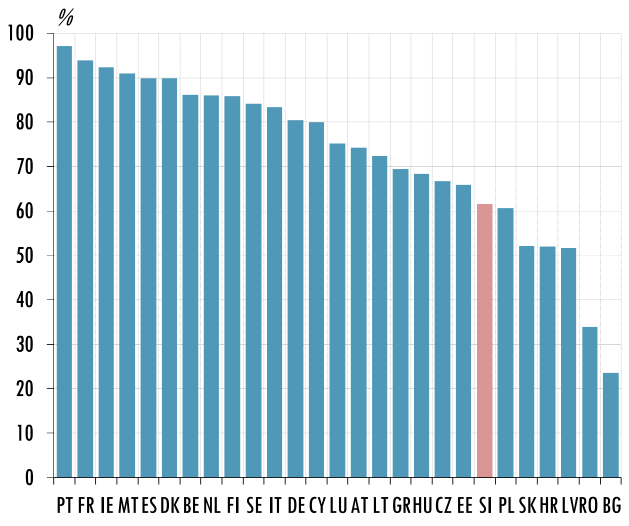
Summary of the assessment on the fulfilment of conditions for the existence of exceptional circumstances in 2022

The Fiscal Council assesses that, based on currently available information and forecasts, the conditions for the existence of exceptional circumstances will continue to be met in 2022. The existence of exceptional circumstances in 2022 only allows for flexibility in the conduct of fiscal policy to directly deal with the challenges brought by the epidemic, while its additional expansionary orientation is not justified according to the Fiscal Council's assessment based on the latest IMAD forecasts. In particular, exceptional circumstances should not be used for the adoption of measures reflecting the final stage of the political cycle. The continuation of exceptional circumstances in 2022 was recommended at EU level by the European Commission in June 2021, which also called for the differentiation of EU Member States' fiscal policies, taking into account differences in the stage of recovery of economic activity and the different risks to the medium- and long-term fiscal sustainability of each country. In this context, the Fiscal Council assesses that in Slovenia excessive fiscal policy support of economic growth based on significant deficits could create macroeconomic imbalances in the coming years, increase the possibilities for the inefficient use of public funds, reduce opportunities to create room for manoeuvre in bad times and make the transition to the correction mechanism process more difficult. Even only the optimal use of available EU grants, which does not worsen fiscal balance, would provide a major boost to economic growth. While the domestic economic situation is improving this year also as a result of support measures, and the outlook is favourable, the sustainability of the recovery is subject to a number of risks, many related to the further course of the epidemic. The recovery is also seen in the labour market, where some indicators already suggest constraints on the supply side. The Fiscal Council expects that, once none of the both conditions for invoking exceptional circumstances is met, the Government will adhere to the implementation of the correction mechanism in accordance with the legislation, ensure that structural measures are in place to prepare for future shocks, and adequately address the challenges to the long-term sustainability of public finances.

The Fiscal Rule Act sets out two conditions for the existence of exceptional circumstances that allow for a temporary deviation from the medium-term balance, provided that it does not jeopardise fiscal sustainability in the medium term. Pursuant to paragraph one of Article 12 of the Fiscal Rule Act[1], such a deviation is only permitted (i) in periods of severe economic downturn or (ii) in the case of an unusual event outside the control of the party concerned which has a major impact on the financial situation of the general government sector, as defined by the Stability and Growth Pact. The Fiscal Rule Act does not set out the criteria for determining the severity of an economic downturn nor the extent of the unusual event having a major impact on the financial situation of the general government sector. Therefore, the Fiscal Council applies in its assessment the criteria for determining the adequacy of conditions which, in its opinion, correspond best to the requirements referred to in the Fiscal Rule Act.

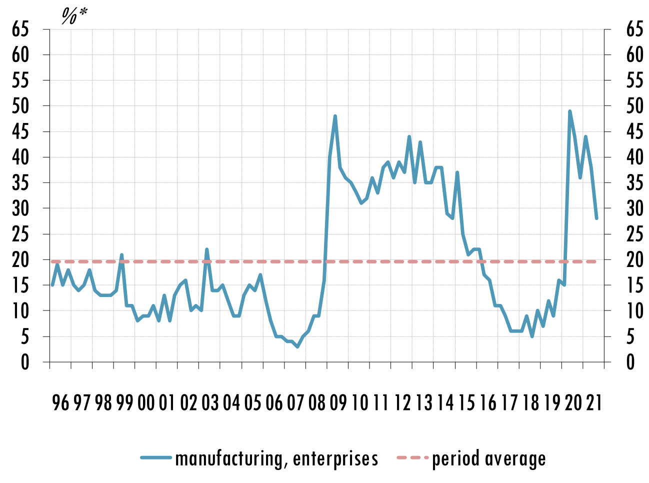
Assessments on the fulfilment of the conditions for invoking exceptional circumstances have been carried out by the Fiscal Council since March 2020 along with each assessment of the budget documents and each time the macroeconomic forecasts underlying the preparation of the budget documents are updated. At the outbreak of the epidemic in March 2020, the Fiscal Council established that the epidemic was an unusual event, which, under Article 12 of the Fiscal Rule Act, allowed exceptional circumstances to be enforced. In accordance with the same Article, the Government can request the Fiscal Council to assess whether exceptional circumstances have arisen or ceased to exist, which was the case in autumn 2020 and spring 2021. The Fiscal Council has so far made three assessments on the existence of exceptional circumstances.[2] In each assessment on the fulfilment of the conditions for invoking exceptional circumstances, the Fiscal Council called for caution regarding the introduction of measures during the period of exceptional circumstances. It also noted that measures adopted to deal with exceptional circumstances should be temporary and should directly address the exceptional circumstances.

Figure 1: Uptake of at least one dose among adults aged 18 years and above



Source: ECDC.

Figure 2: Business tendency survey - limiting factors, uncertain economic conditions



*Note: * Share of enterprises which listed uncertain economic conditions as one of the most important factors limiting production.*
Source: SORS, FC calculations.

[1] http://www.pisrs.si/Pis.web/pregledPredpisa?id=ZAKO7056 – Only in Slovene

[2] The Fiscal Council's assessment to date on the fulfilment of conditions for invoking exceptional circumstances can be found https://www.fs-rs.si/wp-content/uploads/2020/03/Assessment_extraordinary-event-under-the-Fiscal-Rule-Act-_March-2020.pdf (March 2020), https://www.fs-rs.si/wp-content/uploads/2020/10/Exceptional-circumstances_October-2020.pdf (October 2020) and https://www.fs-rs.si/wp-content/uploads/2021/04/Exceptional_circumstances-_april2021_en.pdf (April 2021).

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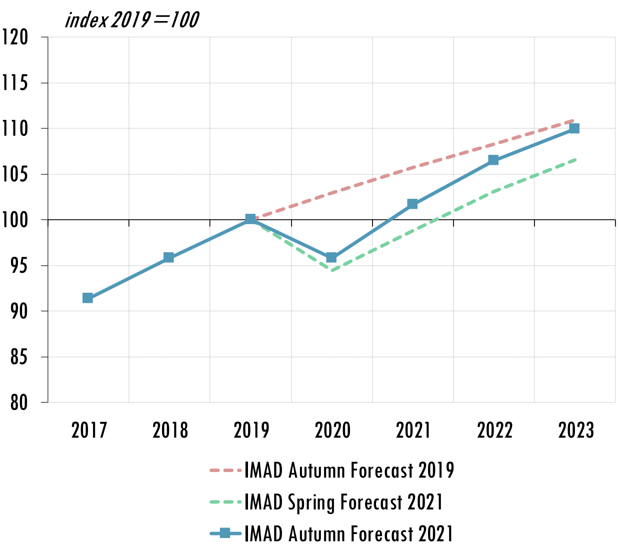
The Fiscal Council assesses that, based on currently available information and forecasts, the conditions for the existence of exceptional circumstances will continue to be met in 2022. The uncertainties relating to an unusual event such as epidemic are a key factor supporting this assessment. Given the current relatively low vaccination rate among the population (Figure 1) and the possibility of new variants of the virus, the epidemiological situation remains uncertain. As a result, the effects of the epidemic and the current and potential additional containment measures on economic activity are also uncertain. According to the latest forecasts, GDP is projected to reach pre-crisis levels as early as 2021 (Figure 3), which suggests that one of the two legal conditions for invoking exceptional circumstances would not be met. On the other hand, fiscal policy measures have contributed significantly to the relatively rapid recovery of economic activity. At the same time, the risks to further growth are tilted on a downside, which calls into question the sustainability of the recovery. In this context, it should be noted that constraints are already emerging, both domestically and internationally, in particular on the supply side, which could lead to new macroeconomic imbalances if fiscal policy is excessively stimulative.

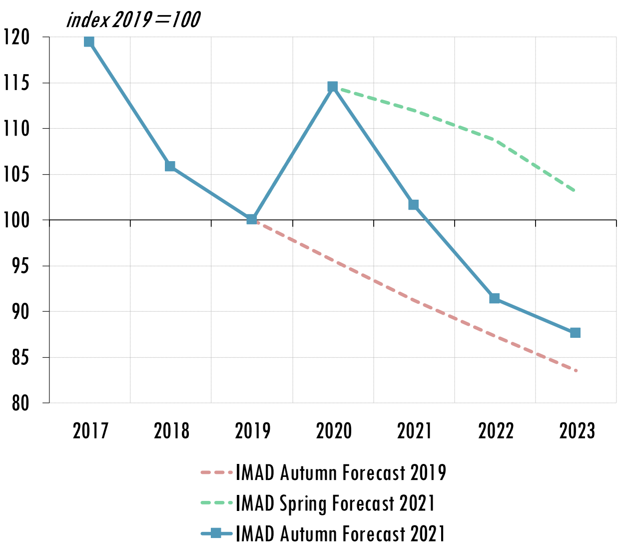
Along with favourable forecasts, the economic picture is improving this year, but the sustainability of the recovery is subject to a number of risks that are mainly related to the epidemic. The recovery has been faster than forecast this spring and, following the revision undertaken by the Statistical Office of the Republic of Slovenia, the decline last year was also much smaller than the first estimates of economic growth. Economic activity has thus almost reached its end-2019 level (the same applies to some types of tax revenue) and, according to IMAD's forecast, this year it is expected to reach its 2019 average level. The rapid recovery of activity to pre-crisis levels is also largely due to the Government's support measures.[3] The recovery so far remains rather uneven given that the service sector activity, which accounts for around one-third of total value added, is not expected to reach the pre-crisis level until 2022. Although the level of total GDP in 2022 is not yet

Figure 3: Real GDP



Sources: SORS, IMAD, FC calculations.

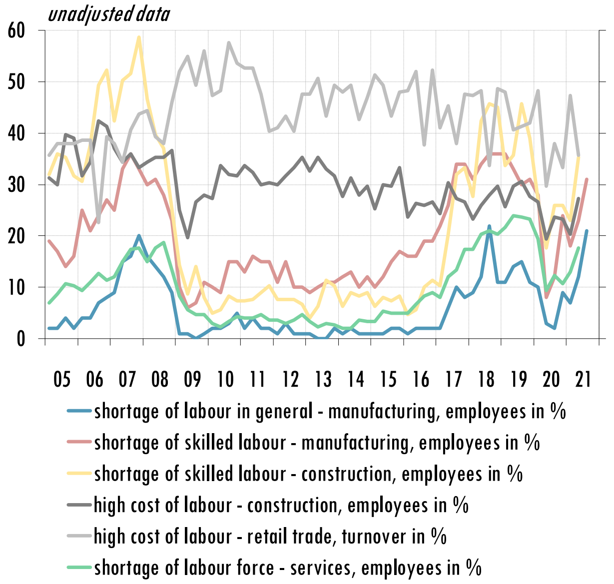
Figure 4: Registered unemployed persons



Source: Employment Service of Slovenia, FC calculations.

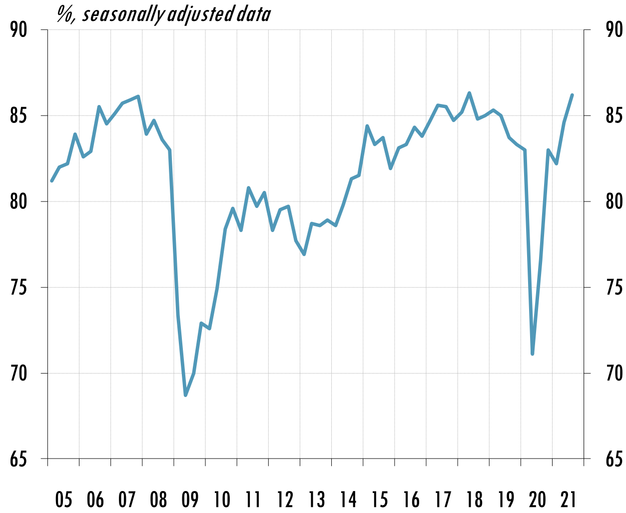
[3] According to IMAD's estimates of the multiplier effects for 2020 presented in the Autumn Forecast of Economic Trends (September 2021), GDP growth in 2021 would, in the absence of Government measures, be about half lower than projected in the latest forecast, and according to the Fiscal Council's January 2021 assessment, updated with this year's measures, GDP growth in 2021 would, in the absence of government measures, be a good third lower than projected.

Figure 5: Business tendency survey - limiting factors, labour



Source: SORS, FC calculations.

Figure 6: Capacity utilisation in manufacturing



Source: SORS.

expected to reach the activity level predicted before the crisis, current projections foresee a rather robust recovery in aggregate activity in both 2022 and 2023. The recovery also includes significant government incentives, mainly in terms of investment. Risks to future economic growth are overwhelmingly linked to the epidemic, both directly and indirectly. The direct risks mainly relate to the extent and duration of the epidemiological situation and possible restrictive measures that would hamper the functioning of the economy. Indirect risks are associated in particular with uncertain behaviour, i.e. the adaptation of both individuals and companies to emerging situations. Lastly, the measurement of economic activity itself is also uncertain due to the difficulties in the collection of statistical data and their subsequent revisions, which were significant, especially at the time of the last release of the national accounts data.

Although with some delay, the recovery is also visible in the labour market, where some indicators already point to supply-side constraints. According to IMAD's forecasts, the number of registered unemployed persons is expected to be slightly higher in 2021 than in 2019, before falling below the pre-crisis level in 2022 (Figure 4). It should also be noted that in mid-2021, according to currently available data, there were still approximately 27,000 people included in job retention measures (furlough scheme, part-time work, quarantine and force majeure), who could potentially become unemployed when these measures expire. At the same time, the survey indicators of limiting factors in production suggest that businesses are already facing a shortage of an adequately qualified labour force and an increasing shortage of workers in general (Figure 5).

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The Fiscal Council assesses that excessive fiscal policy support for economic growth in 2022 and beyond may result in macroeconomic imbalances and may increase the risks of public funds not being used efficiently. The production capacity utilisation rate in the manufacturing industry has already reached historically high values (Figure 6). IMAD's current forecasts and the Fiscal Council's estimates suggest that the aggregate output gap is also expected to turn positive in 2021 and 2022, respectively, and the estimates for the following years point to a persistence of the positive output gap.[4] This could hamper the ability of the supply side of the national economy to respond to the expected high demand as early as 2022, which could give rise to new imbalances in the labour market in particular, which could in turn also be reflected in pressures on labour costs and, consequently, on prices. The pressure is also increasingly present in the international environment due to problems caused by logistics links and rising raw material prices. Along with the limited absorption capacity of the administration, all of the above would increase the likelihood of increasing the costs of investment projects which, according to the plans presented so far, are to be largely implemented by the State and supported by EU funds and, to an even greater extent, by domestic funds. The track record of public investments in 2021 also confirms the warnings given that their projections were too optimistic.[5] The Fiscal Council therefore expects that the updated investment plans will be realistic and will be selected by also considering the likely government expenditure incurred by the operation of the acquired fixed assets. Priority in terms of implementation should be given to projects that address long-term challenges to the greatest possible extent and those that are financed by the European funds. The most recently presented budgetary plans suggest that the strengthening of investment activity is to be predominantly driven by domestic funds, which may contribute significantly to the excessive expansionary fiscal policy stance.

The existence of exceptional circumstances in 2022 therefore only allows for flexibility in the conduct of fiscal policy in order to directly address the challenges brought by the epidemic and for a gradual withdrawal of supportive policies. In 2021 (March and June), the European Commission published two recommendations concerning the implementation of the general escape clause, which allows EU Member States to temporarily depart from the guidelines applicable under normal circumstances.[6] In addition to noting that the EU-wide general escape clause would continue to apply in 2022, the Commission also provided guidance that fiscal policy should remain supportive throughout 2021 and 2022.[7] For 2022, it called for the differentiation of EU Member States' fiscal policies, taking into account differences in the recovery of economic activity and the different risks to the medium- and long-term fiscal sustainability of each country. Thus, given the recovery in economic activity and the fact that Slovenia is among the countries with higher risks to the sustainability of public finances, also due to the above-average increase in debt during the epidemic, the Fiscal Council's interpretation of the existence of exceptional circumstances in 2022 is also in line with the European Commission's guidance.

The invocation of exceptional circumstances should not be used for the adoption of excessive measures reflecting the final stage of the political cycle. The experience gained since the beginning of the epidemic shows that, in Slovenia, part of the funds earmarked for the prevention and containment of the effects of the epidemic were spent in a way that was untargeted and therefore sub -optimal in view of the actual epidemiological or macro-economic circumstances, where finds were also used to a significant extent to address systemic issues. In the stage of the still fragile economic recovery, which is currently still being supported by both fiscal and monetary policies, measures that

[4] According to the definition of the European Commission, this would already go well beyond the definition of the "normal" part of the economic cycle and would thus reflect a high economic growth (see the Vade Mecum on the Stability and Growth Pact 2019 Edition, available at https://ec.europa.eu/info/sites/default/files/economy-finance/ip101_en.pdf).

[5] According to the currently available data on the outturn of government budget expenditure by the end of August, investments in the period of September–December 2021 should increase by the same level as it was in the entire 2020 in order to achieve the planned value of investments in the adopted state budget for 2021. See also Fiscal Council's Monthly Information (September 2021), available at: https://www.fs-rs.si/monthly-information-september-2021/.

[6] The recommendations are available at: https://ec.europa.eu/info/sites/default/files/economy-finance/1_en_act_part1_v9.pdf (March 2021) and https://ec.europa.eu/commission/presscorner/api/files/document/print/en/ip_21_2722/IP_21_2722_EN.pdf (June 2021). In the latter, the European Commission concluded on the basis of its spring forecast that the general escape clause would continue to apply in 2022 and that the reasons for its validity would cease to exist in 2023.

[7] Similar conclusions have also been made by the IMF, the OECD and the European Fiscal Council.

would weaken the structural position of public finances and that do not include instruments to ensure their medium-term fiscal balance should be avoided. Accordingly, the European Commission calls for a better quality of public finances to help address long-term challenges.

In the given circumstances, the Fiscal Council will therefore place particular emphasis on current expenditure projections when assessing the autumn budget documents. The European Commission also warns that current expenditure growth needs are to be restricted, especially in countries with higher levels of public debt. This also applies to Slovenia, where general government gross debt increased above average during the crisis vis-à-vis other EU countries.

The Fiscal Council expects that, once none of the conditions for invoking exceptional circumstances is met, the Government will adhere to the implementation of the correction mechanism in accordance with the legislation. Article 14 of the Fiscal Rule Act provides that the minister responsible for finance will implement measures as defined in the Act governing public finance for the purpose of balancing public finance in the medium term if the Government, on the basis of an assessment of the Fiscal Council, determines that circumstances referred to in paragraph one of Article 12 of the aforementioned Act have ceased to exist and that the structural balance of the general government sector is lower than the minimum value as defined in paragraph three of Article 3 of the aforementioned Act. The Fiscal Council also expects that, once the correction mechanism is in place, fiscal policy will be conducted in a manner consistent with the applicable legislation governing fiscal rules, ensuring that structural measures are in place to prepare for future shocks and adequately address the challenges to the long-term sustainability of public finances.