Speech of the President of the Fiscal Council on the presentation of the Assessment of budget documents for 2022 and 2023 at the National Assembly of the Republic of Slovenia (22 October 2021)

Ladies and Gentlemen,

In the current situation, our assessment of the compliance of budget documents with rules prescribed by law is merely indicative. Such a discussion is not particularly productive even under normal circumstances, mainly due to the familiar problems with the calculation of the output gap.

The fiscal situation is currently not good. The realisation of the documents discussed today will have a crucial impact on the fiscal condition of the state when facing the many challenges that await us. The extensive measures put in place to mitigate the effects of the epidemic require a clearly structured debate on public finance.

Let me first address the legislative basis:

In September, the Fiscal Council assessed that the conditions for the **existence of exceptional circumstances** will continue to be met in 2022 – especially due to the uncertainty about the further course of the epidemic. In our estimate, it only allows for flexibility in the conduct of fiscal policy in order to directly address the challenges brought by the epidemic. At the same time, exceptional circumstances must not be used for the adoption of measures that reflect the final stage of the political cycle.

To facilitate an understanding of the risks to the medium-term sustainability of public finances, let me briefly summarise the developments in **2021**. The Government has prepared a proposal to amend the Framework for this year, which will not be discussed by the National Assembly until early November. The Fiscal Council already forwarded its opinion on the proposed amendment to the Framework to the Government and the National Assembly in early October. This proposal is very important for the assessment of future plans – mainly because the Government has not prepared a supplementary budget for this year. Although the amendment to the Framework without the accompanying supplementary budget is supposedly in line with the legislation, transparency suffers as a result. Upon the adoption of the supplementary budget, regular commitment appropriations should be adjusted to the actual out-turn this year, which is lower than expected. Only then would an appropriate basis for the preparation of plans for the next two years be established.

In the presentation of the opinion of the Fiscal Council regarding the considered budget documents, I will highlight the three components of the expenditure side of the budgets. These are: epidemic-related expenditure, current budgetary expenditure and investments.

The **epidemic and the measures put in place to mitigate its effects** are the key reason for the significant deterioration in public finances last year and this. The measures were similar to those in other countries and largely in line with the guidelines that they should be temporary and aimed at addressing the immediate effects of the epidemic. The measures, amounting to around 5% of GDP per year in 2020 and 2021, made an important contribution to cushioning the decline in economic activity last year and to supporting the recovery this year. Nevertheless, certain shortcomings have emerged in the framework of measures, in particular in the payment of bonuses. The latter amounted to over 900 million euro by the end of September. In addition to questions about the eligibility of such large-scale payments, there is also a risk that temporary bonuses will transpire into a permanent increase in the wage bill in the face of already perceived union pressure. As expected, the planned expenditure for controlling the epidemic in the next two years are lower than last year and this year, and is transparently presented in the documents.

Based on the proposed budget documents for **2022 and 2023**, the **general government deficit**, excluding expenditure on COVID-19 measures, is expected to increase significantly both this year and next as a result of expenditure growth. The deficit in 2023 is still expected to exceed that in 2021, although revenues are expected to be around 10% or 2 billion euro higher.

The projected significant increase in total expenditure is significantly contributed to by the **increase in current expenditure**, which should be limited in the face of a sharp increase in public debt. Such are also the warnings of the European Commission. The growth in current expenditure, i.e. excluding measures to mitigate the effect of the epidemic and investments, is expected to be well above the long-term average this year and the next. We would like to point out, however, that in order to achieve the projected out-turn in 2021, current state budget expenditure without the effects of COVID-19 measures and investments should increase by as much as 20% in the last three months of the year after 6.5% growth in the first nine months. We estimate that such growth has no basis in the current legislation and will actually be lower at the end of the year. This is mainly why we expect the deficit in 2021 to be lower than expected as well. The proposed expenditure levels in 2022, following the lower actual out-turn this year, will therefore show even higher growth than they do now and that would be justified by the legislation currently in force. The Fiscal Council estimates that such fiscal planning opens the way for measures to be taken in the final phase of the policy cycle which could lead to inefficient spending or a structural deterioration of the fiscal situation.

The planned deficit reduction in 2023 is expected to be mainly due to the projected reduction in current expenditure growth. Current expenditure is projected to stagnate or even decrease in 2023. Its change in 2023 is expected to be well below the long-term average. In particular, the projection of a very low increase in the compensation of employees and the unchanged level of expenditure on social benefits stand out. At the same time, the presented budget documents lack a presentation of the measures to ensure such low growth.

Let me now address investments. The Fiscal Council shares the Government's opinion that **public investments** can make an important contribution to kick-starting the economy in the short term and to building resilience and increasing economic potential in the long term, but only if they are well targeted and implemented effectively. The level of general government investment, on average, is set to rise to around 6.5% of GDP over the next two years, which is well above its highest levels ever, reaching a maximum of 5%. The decrease in the investment out-turn estimate for this year in comparison to the current budget confirms our previous assessment that the plans in this area exceed the absorption capacity of the economy and the administration. Some indicators, especially from the labour market, already show a shortage of available workers. As a result, companies report rising costs of projects due to rising labor costs. As plans regarding a large number of extensive projects are implemented, the risk of inefficient project implementation and also of creating macroeconomic imbalances increases.

Under such conditions, it would make sense to give priority to projects financed by European grants, where control over the efficiency of spending is also stricter. It is necessary to draw attention to the historical overestimation of revenues from EU funds in planning, which we regularly point out. The Court of Auditors also found in a recent audit that the planning of European cohesion policy funds for the 2014–2020 period was too optimistic. According to budgetary plans, the increase in public investment is expected to be around two-thirds driven by an increase in domestic funding, and only one-third by an increase in EU funding. The Fiscal Council therefore believes that the realisation of domestic-funded investments should be more closely aligned with cyclical conditions and the absorption capacities of the economy. In practice, this means that the start of a certain part of the projects should be postponed and the implementation of the planned projects should be distributed over a longer period of time.

According to the Government's plans, **public debt** is expected to remain much higher in 2023 and 2024 than before the crisis, at just below 80% of GDP. It does not matter so much whether the debt increase during the epidemic was more or less than the EU average. The fact is that it has increased by about 15% of GDP and is high. We should remember that it took us four years, from 2015 to 2019, to reduce the debt from a similarly high level of approximately 80% of GDP after the recovery of the banking system to approximately 65% of GDP. This created room for manoeuvre that allowed us to act as extensively as we did during the epidemic. We succeeded in reducing our debt amid relatively high economic growth, the ECB's extremely favourable monetary policy, which reduced interest costs, and a number of discretionary measures that were understandably unpopular.

Over the last decade, we have witnessed three unexpected crises leading to a sharp rise in public debt. As a small open economy, Slovenia cannot afford to see its public debt increase by 15% to 20% of GDP after each crisis and then stabilise at higher levels. In the first place, creating room for manoeuvre is necessary because of the already known major challenges that we will have to face. These are primarily the challenges of an ageing population and the green transition. At the same time the possibility of a reversal of the highly stimulative monetary policy, which is a key contributor to the current low financing costs, is increasing. This suggests that in the future we will no longer be able rely on interest expenditure cuts to find room for the fiscal policy to work.

Finally, I would like to emphasise that the basic orientation of fiscal policy is generally appropriate, but the plans are accompanied by a number of important risks that, if materialised, may have serious consequences for the sustainability of public finances. Let me therefore conclude by summarising the key findings of the Fiscal Council:

- Given the relatively favourable macroeconomic trends and forecasts presented by the Director of IMAD, it is necessary to note the recommendations of international organisations that the fiscal policy must be adjusted to the state of the economy.
- We agree that the fiscal policy environment is uncertain, but this should not be a reason to produce budget documents which, in our view, reflect unrealistic planning to some extent. A credible medium-term budgetary framework could also make an important contribution to keeping financing costs low in the future, according to recent analyses by the International Monetary Fund.
- In our assessment, the proposed budget documents set out a more stimulative fiscal policy for the coming years compared to the documents currently in force, although supply-side constraints are already emerging.
- This increases the risk that the temporary exceptional increase in public spending, which was

largely justified because of the epidemic, could turn into a structural and thus permanent deterioration of public finances.

- According to the Fiscal Council's assessment, the realisation of the favourable macroeconomic outlook and the high liquidity of the state budget, even with more moderate public expenditure growth than currently projected, would allow for a faster reduction of debt without jeopardising the economic recovery.
- Fiscal policy should, to a greater extent than indicated in the budget documents, strike a balance between the need to create room for manoeuvre to address long-term challenges and cope with future crises on the one hand, and effectively strengthen the long-term economic potential and resilience, and boost the economy in the short term on the other.