REPUBLIC OF SLOVENIA
FISCAL COUNCIL

Fulfilment of conditions for the existence of exceptional circumstances in 2023

September 2022

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Data available up to and including 19 September 2022 were used. The material has been prepared following a request made by the Government of the Republic of Slovenia to the Fiscal Council on 15 September 2022 regarding the existence of exceptional circumstances in 2023.

The existence of exceptional circumstances in 2023

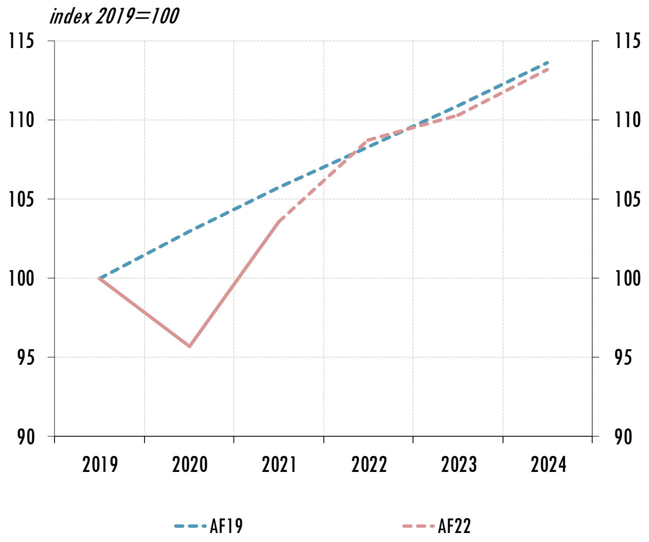
The outlook for 2023 is currently characterised by extreme uncertainty, which requires flexible government action, and high risks of a further deterioration in the economic growth outlook, which could have important financial implications for the general government sector's financial position. While taking urgent action to limit the impact of the energy price increases, the Government needs to preserve as much room for manoeuvre as possible for future action, in particular by limiting the growth of current spending. Measures to address the energy crisis must be timely, targeted and temporary and must not worsen the structural position of public finances. In the event of uncertain duration of price shocks, this is particularly true for the adjustment of different categories of public expenditure to the current high level of energy prices.

The Fiscal Rule Act (the FRA) sets out two conditions for the existence of exceptional circumstances that allow for a 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, such a deviation is only permitted (i) in periods of severe economic downturn or (ii) in the event of an unusual event outside the control of the party concerned that 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 whether an economic downturn is severe or how large the impact of an unusual event must be to have a significant impact on the financial position 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.

The Fiscal Council has been carrying out assessments on the fulfilment of the conditions for invoking exceptional circumstances since March 2020, as a rule, at the time of each assessment of the budget documents. 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 invoked. 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, on its own initiative, prepared an assessment on the fulfilment of the conditions for invoking exceptional circumstances in autumn 2021.[1] At that time, it concluded that the conditions for invoking exceptional circumstances in 2022 were fulfilled, but due to uncertainties, it did not make an assessment of exceptional circumstances in 2023. When analysing the circumstances in spring 2022, the Fiscal Council announced that it would take its decision on extending the exceptional circumstances to 2023 before the consideration of budget documents in autumn 2022. In each assessment on the fulfilment of the conditions for invoking exceptional circumstances, it called for caution in introducing measures during the period of exceptional circumstances. It has also regularly stressed that measures to address exceptional circumstances must be temporary and must directly address the exceptional circumstances.

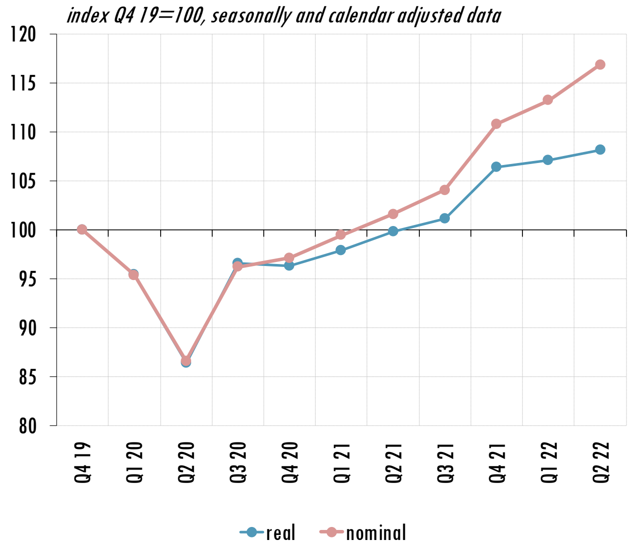
[1] The Fiscal Council's assessments to date on the fulfilment of conditions for invoking exceptional circumstances can be found at:
https://www.fs-rs.si/wp-content/uploads/2020/03/Assessment_extraordinary-event-under-the-Fiscal-Rule-Act-_March-2020.pdf (March 2020),
https://www.fs-rs.si/wp-content/uploads/2020/10/Exceptional-circumstances_October-2020.pdf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

Figure 1: Real GDP



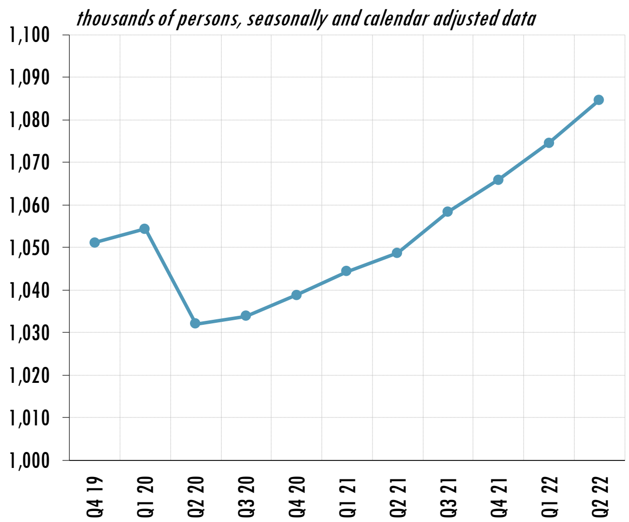
Source: SORS, IMAD, FC calculations.

Figure 2: GDP (quarterly)



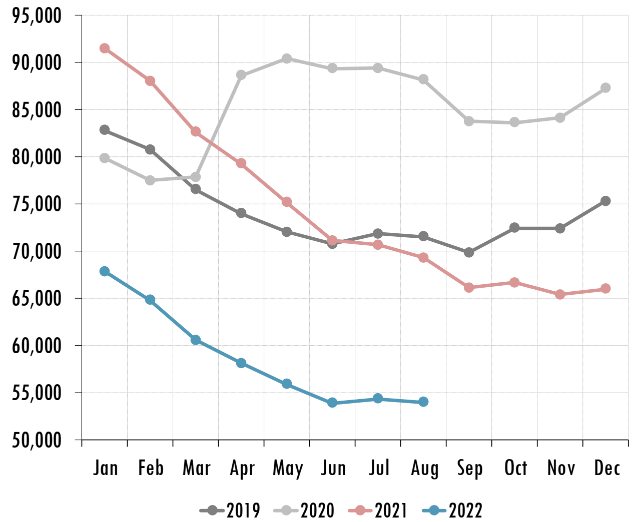
Source: SORS, FC calculations.

Figure 3: Employment (domestic concept)



Source:SORS.

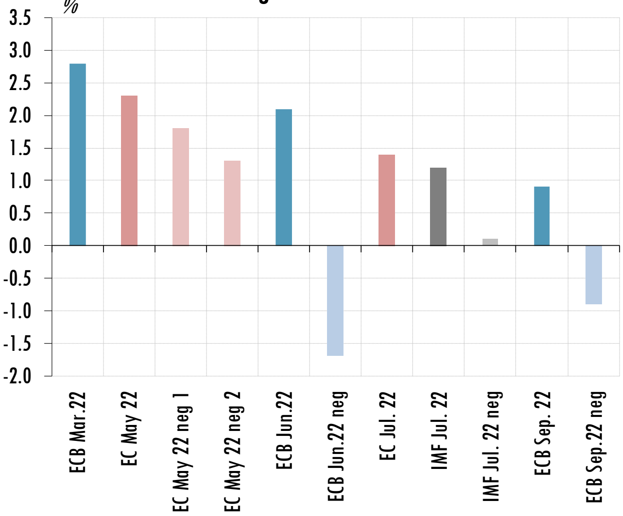
Figure 4: Number of registered unemployed persons



Source: Employment Service of Slovenia.

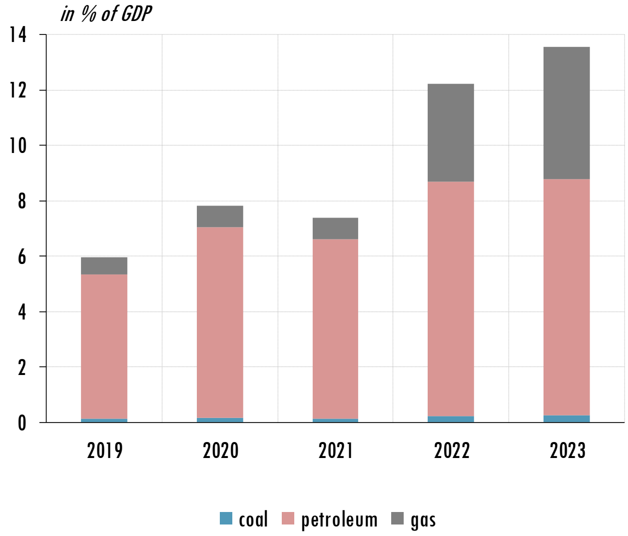
The current economic situation is not a sufficient reason to invoke exceptional circumstances in 2023. Economic activity and employment levels in Slovenia already exceeded their pre-crisis levels on average in 2021, their exceeding the pre-crisis levels being among the highest in the EU. According to the updated IMAD projections, GDP and employment levels next year are expected to remain at the levels projected in autumn 2019. The same is true for all components of domestic spending, which has increased since the lifting of restrictive measures, with its growth being reflected in an increased readiness to spend. This was made possible by households' savings made during the crisis and the still favourable financing conditions, combined with significant crisis support from the state to households and businesses. The favourable economic situation has also been reflected in the labour market, with unemployment at an all-time low, companies reporting difficulties in recruiting suitably skilled labour and foreigners accounting for the majority of new hiring.

Figure 5: Forecasts and scenarios of euro area real GDP growth for 2023



Sources: ECB, EC, IMF. Note: "neg" denotes negative scenarios in respective forecasts.

Figure 6: Energy imports at constant 2019 quantities



Source: SORS, BoS, FC calculations.

Since the Fiscal Council's last assessment on the fulfilment of the conditions for invoking exceptional circumstances, uncertainties have increased significantly and the outlook for future economic growth has deteriorated. This is reflected, among other things, in a gradual lowering of GDP growth forecasts and alternative scenarios that also point to the possibility of a recession in the EU, the euro area and Slovenia.[2] The main reason for the increased uncertainties is the escalating geopolitical situation, which is affecting both foreign demand and commodity prices, in particular energy prices. We estimate the macroeconomic shock from higher prices of energy products to be around 6% of GDP in 2023 compared to 2019, with an additional almost 2% of GDP compared to 2022. The scale of the shock justifies intervention by the state, but part of the shock should also be absorbed by businesses and households.

Significant uncertainties and shocks also reduce the reliability of statistics and input data for assessing compliance with fiscal rules. In an epidemiological crisis, the data that serve as the basis for budget planning are extensively revised. Thus, in the last revision of annual data, the Statistical Office of the Republic of Slovenia significantly revised its preliminary estimates of certain macroeconomic aggregates for 2021.[3] During and after an epidemiological crisis, the structure of the economy rapidly changes.[4] The resulting wide ranges of output gap estimates imply a high variability of the variable,[5] which, according to the Fiscal Rule Act, is fundamental for determining the compliance of budget documents with fiscal rules.

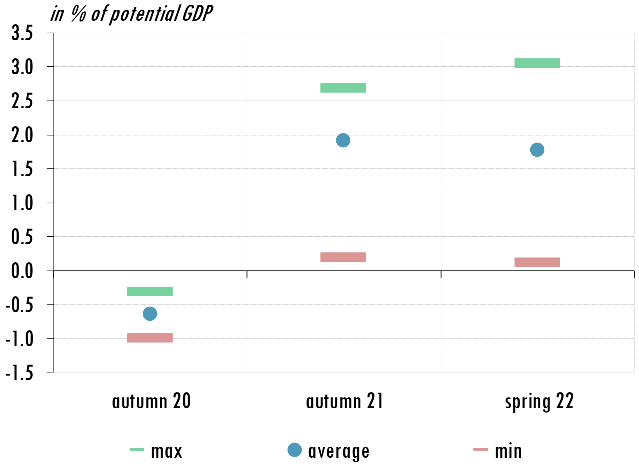
[2] For example, the scenario described in Box 3 of the ECB's projections (available at https://www.ecb.europa.eu/pub/pdf/other/ecb.projections202209_ecbstaff~3eafaaee1a.en.pdf). In preparing the scenario, the EC assumed that the bulk of the impact of the realisation of the risks would materialise in 2022 (see Chapter 4 of the spring forecast, available at https://economy-finance.ec.europa.eu/system/files/2022-05/ip173_en.pdf). According to the estimates of the downside scenario in IMAD's autumn forecast, recession could also occur in Slovenia. With a negative shock, GDP growth in the baseline scenario (1.4%) could fall by 2–2.5 percentage points in 2023. IMAD's autumn forecast is available at https://www.umar.gov.si/fileadmin/user_upload/napovedi/jesen/2022/angleski/aJNGG_2022.pdf.

[3] In particular nominal consumer spending (EUR -630 million), compensation of employees (EUR 631 million), gross operating surplus (EUR -476 million) and also gross fixed capital formation (EUR 136 million). Changes at the GDP level were not so significant, with nominal GDP changing by only around EUR 180 million or 0.3% at the time of the revision and the growth rate of real GDP by 0.1 percentage points.

[4] During the crisis, among other things, a significant part of service activities has been temporarily halted, resulting in labour market shifts and uncertain responses of businesses to hiring and investment in the context of the current high energy prices, which also reduces the reliability of potential output estimates. The unreliability of potential output estimates and hence of the output gap is also affected by the fact that energy products are not included in the typical production functions used to assess the state of the economic cycle. Energy, alongside capital and labour, began to be included in the production function in the 1970s, in the wake of the oil crisis, and on a larger scale more than a decade ago in the pursuit of addressing climate change. See, for example, Brockway et al. (2017). Available at https://www.mdpi.com/1996-1073/10/2/202/pdf?version=1487300642

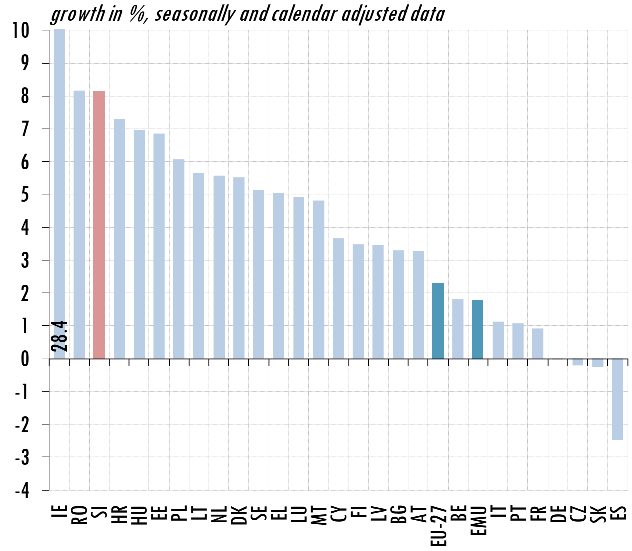
[5] Uncertainties about the size of the output gap are already high in a normal economic situation. See, for example, Chapter 2.3, "Variability of output gap estimates" (Report on the Fiscal Council's operations in 2017).

Figure 7: Output gap 2023*



*Source: IMF, EC, OECD, MoF, IMAD, FC calculations. Notes: * calculations refer to estimates of the five institutions which were made in the reference period, if they are available.*

Figure 8: Real GDP Q2 22/Q4 19



Source: Eurostat, FC calculations.

The European Commission has justified the extension of the escape clause to 2023 mainly on the grounds of high uncertainties. The European Commission stated its opinion on the use of the general escape clause in 2023 in its press release on the European Semester Spring Package on the basis of the May 2022 forecast.[6] It concluded that, in view of the heightened uncertainties and high risks associated with the war in Ukraine, the energy price shocks and continued supply chain disturbances, there is a need to provide sufficient space for national fiscal policies to react in 2023 as well. In June 2021[7], on the basis of its spring forecasts, the European Commission concluded that the grounds for the validity of the general withdrawal clause would expire in 2023. Also according to the March 2022 press release,[8] which was prepared on the basis of the February forecast, the general escape clause was to be deactivated as of 2023. At the time, the European Commission used the level of GDP in the EU and the euro area relative to the pre-crisis level at the end of 2019 as the main indicator for assessing whether the conditions for activating the general escape clause were met.[9]

When extending the escape clause to 2023, the European Commission stressed the need for prudent fiscal policy. It stressed that expansionary fiscal policy in 2023 was not appropriate and that support should be appropriately differentiated between countries at different stages of the business cycle and facing different risks to public debt sustainability. It stressed the importance of implementing investments aimed at the green and digital transition and at ensuring energy security, to which European mechanisms funds can make an important contribution, and warned against excessive increases in current primary expenditure. In the context of the latter, it supported targeted and temporary measures to mitigate the energy crisis. It also highlighted the importance of medium-term budgetary plans which should present in a credible manner a gradual fiscal consolidation, taking into account the challenges of fiscal sustainability.

[6] https://ec.europa.eu/commission/presscorner/api/files/document/print/en/ip_22_3182/IP_22_3182_EN.pdf
[7] https://ec.europa.eu/commission/presscorner/api/files/document/print/en/ip_21_2722/IP_21_2722_EN.pdf
[8] Communication from the Commission to the Council: Fiscal policy Guidance for 2023. COM(2022) 85 final. March. European Commission. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0085
[9] According to the February 2022 forecast, the level of GDP in the EU and euro area, on average, was expected to exceed that of the end of 2019 by the end of 2021 and in all EU Member States by the end of 2022. The May 2022 forecast indicated a similar trend, and data for the second quarter of 2022 confirm the forecasts.

The European Commission's decision to extend the escape clause is largely discretionary and horizontal, consequently limiting the room for autonomous decisions by national independent fiscal institutions. According to the European Fiscal Board[10], such decisions undermine the credibility of economic governance in the EU based on fiscal rules. In extending the escape clause to 2023, the Commission also refrained from taking into account the indicator (GDP level relative to the last quarter of 2019) used in previous decisions. The European Commission has made its fiscal policy recommendations at the EU aggregate level, without taking into account the fact that Member States' economies are at different stages of the business cycle. This, together with the discretion to extend the escape clause, may also hamper monetary policy efforts to achieve price stability, given the tendency for fiscal policy to operate asymmetrically with respect to the economic cycle. Finally, the discretion to adapt decisions and indicators to current needs also makes it more difficult, reduces credibility and limits the room for recommendations by national independent fiscal institutions.

The Fiscal Council will assess the implementation of the fiscal rules in accordance with the applicable legislation, as deviations are only allowed for measures to address exceptional circumstances that have significant implications for the financial position of the general government sector. The Fiscal Council works in accordance with the Fiscal Rule Act. Accordingly, in its analysis of the position of public finances, while emphasising a qualitative assessment of the appropriateness of the fiscal stance, it also uses quantitative indicators of the structural position of public finances and fiscal effort, despite the uncertain situation and therefore uncertain calculations. In the context of a multifaceted response to mitigate price increases, the Fiscal Council expects the Government to transparently and credibly define the measures and evaluate their impact on public finances in order to be able to assess the state of fiscal policy excluding these measures. In its assessments, the Fiscal Council will largely take into account alternative quantitative indicators, in particular differently defined indicators of current expenditure.

The Fiscal Council expects that, once the conditions for exceptional circumstances are no longer fulfilled, the Government will proceed with the implementation of the corrective mechanism in accordance with the national 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 Fiscal Rule Act have ceased to exist and that the structural balance of the general government sector is lower than the minimum value set out in paragraph three of Article 3 of the Fiscal Rule Act. The Fiscal Council will continue to assess budget documents in accordance with the applicable national legislation. In line with the latter, it expects measures to be put in place to ensure that public finances are prepared to respond to future shocks and that challenges to long-term fiscal sustainability are adequately addressed. The intentions set out by the Government in this regard when requesting an assessment of the existence of exceptional circumstances in 2023 are therefore appropriate.[11]

[10] https://ec.europa.eu/info/system/files/efb_assessment_of_euro_area_fiscal_stance.pdf

[11] See the press release following the 15th session of the Government of the Republic of Slovenia, available at: https://www.gov.si/en/news/2022-09-15-15th-regular-session-of-the-government-of-the-republic-of-slovenia/