REPUBLIC OF SLOVENIA
FISCAL COUNCIL

Fiscal Council assessment of the occurrence of exceptional circumstances

April 2025

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Data available up to and including 16 April 2025 were used.

On 10 April 2025, the Fiscal Council received a request from the Government to prepare an opinion on the existence of exceptional circumstances that would allow the activation of the national escape clause as laid down in paragraph two of Article 12 of the Fiscal Rules Act. In its request, the Government did not directly specify the reasons for the conditions giving rise to the exceptional circumstances. However, the reasons are outlined in the draft 2025 Progress Report, which the Fiscal Council was also asked to assess on 10 April 2025. Consequently, the activation of the national escape clause was proposed due to the increase in defence investment needs.

The legal framework for assessing exceptional circumstances and activating the national escape clause is outlined in Articles 7 and 12 of the Fiscal Rule Act[1] and Article 26 of EU Regulation 2024/1263.[2] Article 26 of the Regulation stipulates that: (i) exceptional circumstances are outside the control of the Member State; (ii) exceptional circumstances have a major impact on the public finances of the Member State and (iii) such deviation from the Member State's net expenditure path as set by the Council of the EU does not endanger fiscal sustainability over the medium term. The latter is expected to be ensured within the EU economic governance framework by adhering to the fiscal trajectory outlined in the medium-term fiscal structural plans.[3] The European Commission must establish a timeframe within which such a deviation is permitted. In accordance with point 6 of paragraph two of Article 7 of the Fiscal Rule Act, the Fiscal Council is required to provide the assessment referred to in paragraph two of Article 12 on the existence of exceptional circumstances within eight days.

EU Member States are expected to collectively request the European Commission and the Council of the EU to activate the national escape clause by the end of April 2025.[4] The escape clause would apply for a period of four years, from 2025 to 2028, aligning with the majority of the medium-term fiscal-structural plans prepared last year. During this period, countries are expected to adjust their defence spending to a level that ensures sufficient resilience in response to the emerging geopolitical situation. In this case, the deviation from the fiscal rules currently in force would apply only to additional defence spending. Given these constraints, there would be no need to amend the medium-term plans, which ensure the medium-term fiscal sustainability through the net expenditure path. The current fiscal framework would thus remain in place, and compliance with the fiscal rules would only be assessed for the part of public finances not related to exceptional circumstances.[5]

The escape clause is expected to allow an increase in defence spending of up to 1.5% of GDP compared to the base year in all years during which the escape clause is activated. Should the other conditions remain unchanged, this would imply a significant increase in the general government deficit. According to the current medium-term plan, the deficit is projected to average -1.8% of GDP over the 2025–2028 period. The increase under consideration is based on the share of defence expenditure in GDP in the base year 2021, i.e. prior to Russia's attack on Ukraine and the occurrence of exceptional circumstances. This shock will lead to a permanent increase in defence-related government

[1] Available at: https://www.fs-rs.si/wp-content/uploads/2025/05/ZAKO9122_NPB0-lektoriran-prevod_eng_.pdf

[2] The Regulation is available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_202401263

[3] The plans currently prepared for EU Member States, including Slovenia, from autumn 2024 are available at: https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/preventive-arm/national-medium-term-fiscal-structural-plans_en

[4] Recommendation from the Commission Communication on accommodating defence expenditure within the Stability and Growth Pact. The communication is available at: https://defence-industry-space.ec.europa.eu/document/download/a57304ce-1a98-4a2c-aed5-36485884f1a0_en?filename=Communication-on-the-national-escape-clause.pdf

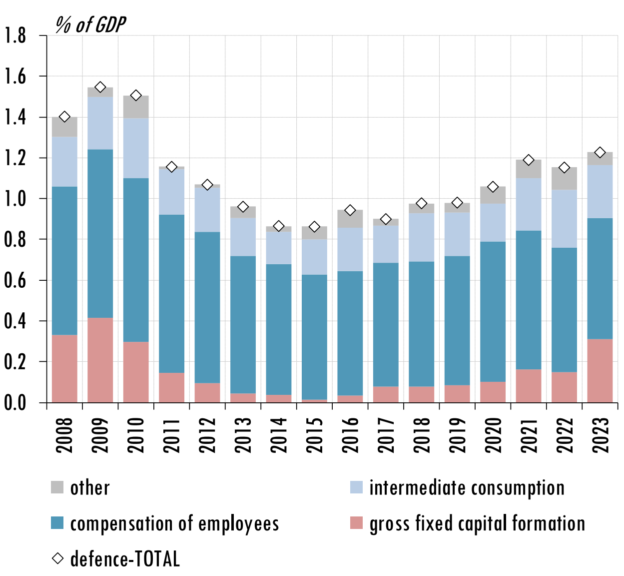
[5] According to Article 22 of Regulation EU 2024/1263, trends in this part of public finances should therefore be indicated in the so-called control account. These trends may also lead to the initiation of an excessive deficit procedure against the state in the event of excessive annual or accumulated deviations. The same article also stipulates that the control account does not record deviations when the escape close is in force. The Communication from the Commission on accommodating increased defence expenditure within the Stability and Growth Pact states that deviations caused by increased expenditure will not be recorded in the control account. Instead, they will be recorded separately and for information purposes only.

expenditure.[6] Therefore, no later than four years after the activation of the escape clause, Member States will need to adjust revenue and/or expenditure due to the structural nature of the shock in order to ensure fiscal sustainability. In this regard, the Fiscal Council's calculations indicate that, in case of a total increase in defence expenditure of up to 1.5% of GDP, Slovenia's public debt trend would be unsustainable in the medium term without the adoption of additional measures.

The Fiscal Council thus emphasises that, even with increased defence spending, ensuring medium-term fiscal sustainability will remain crucial. This is of particular importance from the perspective of a small economy, which may be more vulnerable to potential adverse financial market reactions in the event of macroeconomic and fiscal shocks. One of the conditions for a country's participation in the ECB's Transmission Protection Instrument is the assurance of medium-term fiscal sustainability.[7] Furthermore, the medium-term plans, based on the standardised assumptions used in the debt sustainability analysis, were prepared using simulations of smaller shocks than those likely to occur due to additional defence spending.[8]

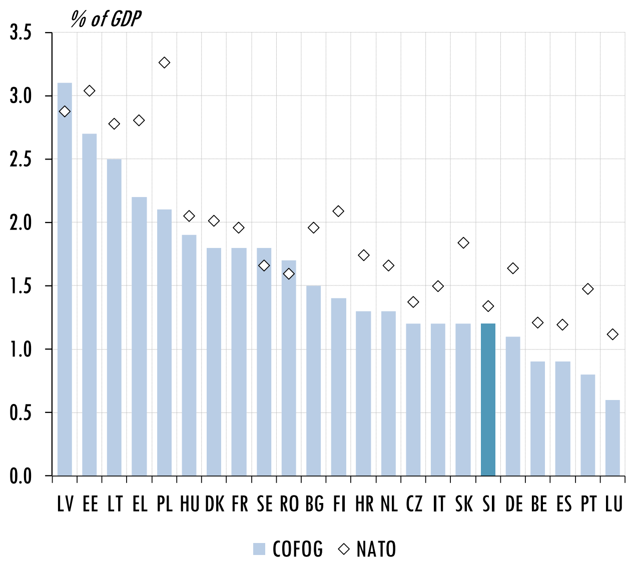
A clear definition and targeted defence spending will be essential for the effective conduct of fiscal policy in the period of exceptional circumstances. The pursuit of additional defence spending is associated with significant methodological challenges. The current information, including that from the aforementioned Commission communication, suggests that defence spending should be taken into account in accordance with the COFOG classification (COFOG-02 division).[9] However, both the timing of data collection (such as the payment of invoices, order or delivery of equipment) and delays in the publication of data under the COFOG methodology[10] (which, although consistent with the ESA2010 national accounts methodology, differs from the NATO methodology) may be inconsistent with the

Figure 1: Defence expenditure (COFOG) - Slovenia



Source: SORS.

Figure 2: Defence expenditure - EU countries, 2023



Source: Eurostat, NATO.

[6] This is in contrast to the expenditure related to the COVID-19 epidemic, the cost-of-living crisis and the floods, the increase of which was only temporary.

[7] See the conditions for participation in the TPI at: https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html

[8] The directly comparable shock included in the preparation of the medium-term plan in the context of the debt sustainability analysis assumes a deterioration of the primary structural balance by 0.25 percentage points of GDP in each of the first two years after the plan period, and the resulting permanent maintenance of a 0.5 percentage points of GDP deterioration relative to the baseline scenario. The actual shock of a gradual increase in defence expenditure by 1.5% of GDP would be three times larger in terms of the primary structural balance. Furthermore, the deterioration of the primary balance would occur earlier than in the case of the aforementioned shock simulation (already during the plan period).

[9] Roughly speaking, this includes the military, civil protection, international military assistance and defence research. The Classification of the Functions of Government is available at: https://ec.europa.eu/eurostat/documents/3859598/10142242/KS-GQ-19-010-EN-N.pdf/ed64a194-81db-112b-074b-b7a9eb946c32?t=1569418084000

[10] They are currently available until 2023; however, they are typically published by SURS 11 months after the end of the previous year.

requirements of regular monitoring of defence expenditure. In this context, the possibility of deviations in defence expenditure for equipment that will be procured but not delivered until after the validity period of the exceptional circumstances should also be taken into account.

The methods of financing additional defence spending will also be important; however, they have yet to be determined. Due to the structural nature of defence spending, it is vital to consider the benefits and conditions of additional borrowing, restructuring and finding reserves in other areas of government expenditure, as well as the creation of conditions for increased revenue, even before the end of the transitional period of exceptional circumstances. The financing of defence spending at the EU level is also not yet fully clarified. As set out in the European Commission document (White Paper),[11] in addition to resources from the regular EU budget, refundable funds from the new SAFE instrument would also be made available. These funds consist of loans with a maximum repayment period of 45 years and deferred principal payments for a period of up to 10 years. It is important to note that, in contrast to grants, loans can increase the deficit of the borrowing country. In addition to the funds of the new multiannual financial framework, repayable funding is also expected to be provided by the EIB and the ESM, as well as by mobilising private capital through the accelerated creation and operation of the Capital Markets Union.

[11] Available at: https://defence-industry-space.ec.europa.eu/document/download/30b50d2c-49aa-4250-9ca6-27a0347cf009_en?filename=White%20Paper.pdf