FISCAL DEVELOPMENTS AND POLICY

Summary

In the last few years the general government deficit has been gradually declining. Owing to the improvement in macroeconomic conditions, banking sector stabilisation and a mix of temporary and permanent measures, the deficit has been narrowing since 2013 and amounted to 1.8% of GDP in 2016. The trend of sharp debt increase recorded since mid-2008 also came to a halt in 2016. Favourable borrowing conditions due to the improvement in the economic situation have also enabled active debt management, with the average debt maturity lengthening further and borrowing costs declining; all of this is reflected in a falling implicit interest rate of public debt. Owing to the adopted measures, not only the cyclical but also the structural component of the budget deficit declined, totalling around 1% of GDP in 2016 according to IMAD's estimate; however, the temporary nature of some of the adopted measures indicates that a decline like this is neither lasting nor entirely sustainable.

The main policy orientation regarding further fiscal consolidation presented in the Stability Programme 2017 (SP 2017) is a gradual easing of the austerity measures adopted during the crisis in circumstances of anticipated further improvement in macroeconomic conditions. The consolidation according to the SP 2017 is based on a conservative estimate of revenue growth and a slower growth in expenditure than in revenue, resulting in the planned general government surplus and a structurally balanced general government budget by 2020. The projected revenue growth arises mainly from more favourable cyclical movements. The relaxation of measures in such circumstances is, however, reflected in a relatively strong increase in the main categories of expenditure (i.e. employee compensation and social benefits and transfers) and also results in the reinstatement of a number of automatic mechanisms that influence their growth.

The envisaged consolidation is surrounded by considerable risks. The planned lagging of expenditure growth behind revenue growth mainly relies on the gradual elimination of the temporary austerity measures in the area of earnings in the general government sector and social benefits and transfers, and their substitution by other systemic measures that have not yet been defined. The projections of the SP 2017 are therefore partly based on assumptions regarding measures that have yet to be specified, particularly for the second part of the projection horizon (wage policy from 2018 onwards, substitute measures after the relaxation of some social receipts in 2019, higher revenue from compensation for the use of building land after 2018); that may prove unsustainable over the long term (low growth in intermediate consumption); or are not realistic relative to the current situation (stagnation of employment in the general government). After the reinstatement of automatic adjustment mechanisms for some expenditures, no substitute measures for adjustment in the event of a worsening of economic conditions have yet been defined. Moreover, SP 2017 projections include no structural measures for ensuring long-term sustainability of public finances. All this points to a risk to the continuation of sustainable fiscal consolidation and, together with the indicators of compliance with the rules of the Stability and Growth Pact (SGP), also to the risk of non-compliance with the rules from 2018. This was also pointed out by the Fiscal Council and the European Commission in their assessments of the SP 2017. These warnings are particularly relevant in the situation where the Slovenian economy is moving into positive output gap territory, which could – were positive macroeconomic risks to materialise – require an even greater fiscal effort and hence an even faster achievement of the medium-term budgetary objective.

In IMAD's assessment, it would be prudent for Slovenia to take advantage of the period of favourable economic trends at home and internationally to consolidate public finances by more permanent structural adjustments. The removal of measures that have been containing expenditure growth in the general government sector in recent years – in the absence of proper mechanisms that would make it possible for Slovenia to take appropriate action over the medium term when economic growth will ease and the effects of

demographic change will be more strongly felt – points to the need for Slovenia to firm up and formulate substitute systemic measures. They should focus particularly on the following areas:

- **Restructuring revenue and expenditure towards greater emphasis on development and efficiency.** On the revenue side, this could include a shift towards higher taxation of property and a further broadening of the tax and contribution bases. On the expenditure side, systemic rationalisations based on detailed overviews of expenditure at all general government levels will be required, as well as allocation of resources to priority areas that ensure economic efficiency and social justice.

- **Reforming social protection systems and adjusting them to demographic change.** Projections of age-related expenditure under a no-policy-change scenario point to the risk that this expenditure may increase relative to GDP soon after 2020. It is often overlooked that these projections already have an impact over the coming years, through their inclusion in the calculation of the medium-term budgetary objective that Slovenia is expected to achieve by 2020 (0.25% of GDP), which will affect the current fiscal and economic policy. The key challenge in reforming the social protection system will therefore be how to formulate a set of measures that will be fiscally sustainable while also preserving the quality of life.

- **Improving state asset management.** This would increase the profitability of state-owned assets and lower the risk of further recapitalisations with public funds.

- **Strengthening growth potential.** In addition to general macroeconomic effects, a prudent and coordinated selection of measures for a sustainable increase in medium-term economic growth would also strengthen fiscal revenue.