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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Slovenia

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Slovenia

{C(2017) 8026 final}

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1. INTRODUCTION

Slovenia submitted its Draft Budgetary Plan for 2018 on 16 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Slovenia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO).

As the debt ratio was 82.6 % of GDP in 2015 (the year in which Slovenia corrected its excessive deficit), exceeding the 60 % of GDP reference value, during the three years following the correction of the excessive deficit Slovenia is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. A box on the application of constrained judgement is contained in this section, given that the plausibility tool indicated that the estimate for the output gap in Slovenia may be counterintuitive. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in July 2017. Section 6 summarises the main conclusions of the present document.

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1. Macroeconomic developments underlying the draft budgetary plan

Based on the most recent data, Slovenia's GDP grew by 3.1 % in 2016 in real terms. This was a positive surprise, as according to the information available for the 2017 Stability Programme, GDP growth was estimated to have reached 2.5 % in 2016. Also the level of nominal GDP in the previous years was revised upwards.

Taking this into account and considering the strong growth in the first half of 2017, it is not surprising that the 2018 DBP revises the growth projections upwards compared to the 2017 Stability Programme. Whereas the Stability Programme projected growth to reach 3.6 % in 2017 and 3.2 % in 2018, the DBP forecasts the economy to grow by 4.4 % in 2017 and 3.9 % in 2018. In particular, the DBP revises the expectations regarding investments and net exports upwards in both 2017 and 2018, whereas consumption is revised slightly downwards in 2017 and moderately upwards in 2018. Inflation expectations have been revised downwards for 2017 based on the observed developments.

The macroeconomic assumptions of the Draft Budgetary Plan for 2017 and 2018 appear plausible. The Commission 2017 autumn forecast projects growth to reach 4.7 % in 2017 and 4.0 % in 2018. In 2017, the Commission forecast has more favourable expectations regarding both the final domestic demand as well as net exports, but overall the composition of growth is relatively similar in both forecasts. In 2018, however, the Commission forecast projects economic growth to be driven by domestic demand while the positive growth contribution from net exports diminishes, as imports increase due to higher investment and consumption.

The risks to the Commission's autumn forecast for Slovenia are tilted to the upside. These are primarily domestic in nature, as the improving sentiment and better access to credit could further support investment, particularly in residential properties. Downside risks are mainly external and relate to the future development of energy and raw material prices.

Box 1: The macroeconomic forecast underpinning the budget in Slovenia

The macroeconomic scenario underpinning the DBP is the Autumn 2017 Forecast of Economic Trends produced by the Institute of Macroeconomic Analysis and Development (IMAD). IMAD is an independent government office, the management of which is responsible directly to the Prime Minister.

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Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.1	3.6	4.4	4.7	3.2	3.9	4.0
Private consumption (% change)	4.2	3.5	3.3	3.4	2.7	3.0	3.6
Gross fixed capital formation (% change)	-3.6	7.0	9.0	9.1	7.0	8.0	9.8
Exports of goods and services (% change)	6.4	6.0	8.8	8.9	5.1	7.5	7.4
Imports of goods and services (% change)	6.6	6.5	8.9	8.7	5.6	7.7	8.4
Contributions to real GDP growth:							
- Final domestic demand	2.0	3.5	3.5	3.7	3.1	3.2	4.0
- Change in inventories	0.7	0.1	0.1	0.0	0.1	0.0	0.0
- Net exports	0.5	0.2	0.7	1.0	0.1	0.6	0.0
Output gap[1]	-0.8	1.1	1.6	1.8	1.9	3.1	3.3
Employment (% change)	1.9	2.2	2.7	2.3	1.5	1.7	1.6
Unemployment rate (%)	8.0	7.0	6.8	6.8	6.4	6.2	5.9
Labour productivity (% change)	1.2	1.4	1.6	2.4	1.7	2.2	2.3
HICP inflation (%)	-0.2	1.8	1.5	1.6	1.6	1.6	1.5
GDP deflator (% change)	0.9	1.0	1.4	1.7	1.7	1.9	1.6
Comp. of employees (per head, % change)	2.8	4.1	3.6	2.8	3.6	4.0	3.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	4.5			5.5			5.2

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

2. RECENT AND PLANNED FISCAL DEVELOPMENTS

2.1. Deficit developments

Despite the upward revision of the macro-economic outlook, the DBP reconfirms the 2017 general government deficit target of 0.8 % of GDP, set in the 2017 Stability Programme and is in line with the Commission 2017 autumn forecast. In 2017, the headline deficit is expected to improve significantly by 1.1 % of GDP, compared to the previous year. The improved macroeconomic context, particularly for employment, is expected to result in buoyant tax and social contributions receipts. After falling by 30 % in 2016, public investment is expected to increase in 2017, along with the implementation of the EU structural funds financial programming period of 2014-2020. Nonetheless, public wages, social transfers, intermediate consumption and subsidies are expected to continue rising compared to the previous year.

For 2018, the DBP targets a general government surplus of 0.4 % of GDP, above the deficit of 0.2 % of GDP targeted in the 2017 Stability Programme. The Commission 2017 autumn forecast also expects a further improvement of the headline balance to a balanced general government budget in 2018. The improvement in the projections comparing to the Stability Programme is mainly driven by higher expected revenues in the DBP. Tax revenues and social contributions are expected to continue to increase in 2018, but less than nominal GDP. Interest expenditure is expected to decrease significantly also as a consequence of active debt management. Conversely, compensation of public employees and expenditure on social transfers are projected to continue to increase due to the reversal of previously taken consolidation measures, measures to remove inconsistencies in the wage system (regarding classification and comparison of different jobs) and an extraordinary indexation of pensions. Public investment is planned to grow significantly in line with the dynamics of the current EU multiannual financial framework which provides co-financing for national investment projects. The latter is reflected in capital transfers received, which are expected to increase significantly, from 0.6 % of GDP in 2017 to 1.3 % of GDP in 2018, while other capital expenditure is planned to decrease noticeably (from 0.6 % of GDP in 2017 to 0.3 % of GDP in 2018).

In its assessment published on 19 October 2017, the Fiscal Council warned that the draft budget for 2018 is only partially compliant with the fiscal rules and called on the government to take additional measures.

The Commission 2017 autumn forecast also expects a further improvement of the headline general government balance, to a budget in balance in 2018. Even though the Commission forecast agrees with the projected strong growth in tax and social security revenues and with the decline in interest expenditure, the Commission autumn 2017 forecast estimates slightly higher growth in public wages, an increase in intermediate consumption in 2018 and a smoother dynamics regarding the absorption of EU funds comparing to what is planned in the DBP. In 2018, public investment is planned to grow by almost 34 % in the DBP (from 3.1 % of GDP in 2017 to 3.9 % of GDP in 2018), while the Commission expects an increase of 15 % (from 3.2 % of GDP in 2017 to 3.5 % of GDP in 2018). In this context, the Commission forecast also expects capital transfers received to increase but at a slower pace than projected in the DBP (to 0.7 % of GDP in 2018), while it expects other capital expenditure to continue constant at 0.6 % of GDP.

The main downside risks to public finances in the coming years stem from building expenditure pressures, particularly on wages and pensions. An additional risk is the emergence of unexpected expenditure one-offs, for instance due to unfavourable court rulings.

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Except for the measures regarding public wages and social transfers (postponing the decided withdrawal of the savings measures taken during the crisis), no further measures are planned to strengthen public finances in 2018.

In structural terms, the DBP implies an unchanged structural balance in 2017 before a 0.5 % of GDP improvement planned in 2018. The Commission 2017 autumn forecast envisages a slight worsening of the structural balance in 2017 (from a structural deficit of 1.5 % to 1.6 % of GDP); in 2018, the Commission expects the structural balance to remain unchanged.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Slovenia currently standing at 0.9 %[1]. Nonetheless, interest expenditure in Slovenia has increased significantly in recent years, from 2.0 % of GDP in 2012 to 3.0 % of GDP in 2016. Based on the information included in the Draft Budgetary Plan, interest expenditure in Slovenia is expected to fall to 2.6 % in 2017 and to decrease further to 1.9 % of GDP in 2018, also due to active debt management.

Against the background of falling interest expenditure, the projected improvement in the structural balance in 2018 (by 0.5 % of GDP) is accompanied by an improvement in the structural primary balance (by 0.2 % of GDP).

In the 2017 stability programme, Slovenia confirmed that the budgetary impact of the exceptional inflow of refugees was significant in 2016 and provided adequate evidence of the scope and nature of these additional budgetary costs. The associated expenditure is estimated at 0.07 % of GDP in 2016 and the required adjustment towards the medium-term budgetary objective for 2016 is reduced to take into account these costs. In the same programme, a similar request was made for 2017, also for 0.07 % of GDP, of which the Commission will only consider the incremental impact, amounting to 0.01 % of GDP. A final assessment, including on the eligible amounts, will be made in spring 2018 on the basis of observed data as provided by the Slovenian authorities for 2017.

[1] 10-year bond yields on 30 October 2017. Source: Bloomberg.

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Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**43.3**	**43.5**	**43.2**	**42.8**	**43.7**	**43.0**	**42.5**	**-0.3**
of which:								
- Taxes on production and imports	14.6	14.7	14.3	14.3	14.4	13.9	14.1	-0.7
- Current taxes on income, wealth, etc.	7.4	7.4	7.6	7.4	7.4	7.6	7.4	0.2
- Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Social contributions	14.8	15.2	14.8	14.6	15.2	14.7	14.5	-0.1
- Other (residual)	6.5	6.2	6.5	6.4	6.7	6.8	6.5	0.3
Expenditure	**45.1**	**44.4**	**43.9**	**43.6**	**43.9**	**42.6**	**42.5**	**-2.5**
of which:								
- Primary expenditure	42.1	42.0	41.3	41.0	41.8	40.7	40.6	-1.4
of which:								
Compensation of employees	11.3	11.4	11.2	11.1	11.2	11.0	11.1	-0.3
Intermediate consumption	6.4	6.3	6.6	6.3	6.1	6.1	6.1	-0.3
Social payments	17.5	17.5	17.0	16.9	17.3	16.5	16.4	-1.0
Subsidies	0.8	0.9	0.9	0.8	1.0	0.9	0.9	0.1
Gross fixed capital formation	3.2	3.5	3.1	3.2	3.8	3.9	3.5	0.7
Other (residual)	2.9	2.4	2.5	2.6	2.4	2.3	2.6	-0.6
- Interest expenditure	3.0	2.4	2.6	2.6	2.1	1.9	1.9	-1.1
General government balance (GGB)	**-1.9**	**-0.8**	**-0.8**	**-0.8**	**-0.2**	**0.4**	**0.0**	**2.3**
Primary balance	**1.1**	**1.6**	**1.9**	**1.8**	**1.9**	**2.3**	**1.9**	**1.1**
One-off and other temporary measures	0.0	-0.4	-0.1	-0.1	-0.4	-0.1	-0.1	-0.1
GGB excl. one-offs	**-1.9**	**-0.4**	**-0.8**	**-0.7**	**0.2**	**0.5**	**0.0**	**2.3**
Output gap[1]	-0.8	1.1	1.6	1.8	1.9	3.1	3.3	3.9
Cyclically-adjusted balance[1]	-1.5	-1.3	-1.5	-1.7	-1.1	-1.1	-1.6	0.4
Structural balance (SB)[2]	**-1.5**	**-0.9**	**-1.5**	**-1.6**	**-0.7**	**-1.0**	**-1.6**	**0.5**
Structural primary balance[2]	1.6	1.5	1.1	1.0	1.4	0.9	0.4	-0.6

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

2.2. Debt developments

After peaking at 82.6 % of GDP in 2015, the general government gross debt fell to 78.5 % of GDP in 2016. In 2017, public debt is planned to be at 75.2 % of GDP and expected to continue on a decreasing path according to the DBP. The implicit interest rate on the state budget debt has been decreasing since 2014. The strategy is to extend the duration of the debt portfolio, reducing the roll-over risk while taking advantage of the current environment of low interest rates to reduce current financing costs. Interest expenditure is expected to decrease as a consequence of active debt management. At the same time, the authorities plan to continue reducing the previously accumulated large cash buffers (estimated to have decreased from 16 % of GDP at end-2015 to 13 % of GDP at end-2016). In 2018, the debt-to-GDP ratio is projected to continue to decline to 71.7 % of GDP on the back of robust economic growth, reduction of interest expenditure and reduction of the previously accumulated cash-buffers.

Similarly to the DBP, the Commission also expects a continued decline in the debt ratio, to 74.1% in 2018. The difference from the ratio of 71.7% forecast in the Draft Budgetary Plan is mostly due to different projections regarding the general government balance and more conservative assumptions concerning the stock-flow adjustment.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**78.5**	**77.0**	**75.2**	**76.4**	**74.3**	**71.7**	**74.1**
Change in the ratio	-4.1	-1.5	-3.3	-2.1	-2.7	-3.5	-2.3
Contributions[2] :							
1. Primary balance	**-1.1**	**-1.6**	**-1.9**	**-1.8**	**-1.9**	**-2.3**	**-1.9**
2. "Snow-ball" effect	**-0.2**	**-1.1**	**-1.6**	**-2.1**	**-1.5**	**-2.2**	**-2.1**
Of which:							
Interest expenditure	3.0	2.4	2.7	2.6	2.1	1.9	1.9
Growth effect	-2.5	-2.7	-3.3	-3.5	-2.3	-2.8	-2.9
Inflation effect	-0.7	-0.8	-1.0	-1.3	-1.2	-1.4	-1.2
3. Stock-flow adjustment	**-2.7**	**1.2**	**0.2**	**1.9**	**0.7**	**1.1**	**1.8**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

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2.3. Measures underpinning the draft budgetary plan

The DBP includes measures to contain public sector pay, in particular by maintaining in force also in 2018 the restrictive payments of the bonuses for work performance and the lagged payments related to work promotion (0.3 % of GDP in 2018). However, the government also took measures to remove inconsistencies of the wage system (classification and comparison of different jobs) which will have a partly offsetting effect. Therefore, overall, the Commission considers the yield coming from the wage measures submitted in the DBP in 2018 to be limited.

Measures to contain social allowances are estimated to reduce spending by 0.1 % of GDP in 2018. Several consolidation measures taken in 2012 in the context of the Additional Intervention Measures Act regarding social transfers will be prolonged into 2018. These measures include the parental leave compensation, which remains at a rate of 90 % with a limited maximum amount, and the restriction of the employment incentive for elderly employees. In addition, the restrictive income eligibility criteria for social scholarships will be partly extended into 2018.

In 2018, the DBP envisages the same amount of one-off expenditures as in 2017 (0.1 % of GDP), in line with the net impact of one-offs included in the Commission 2017 autumn forecast. Both the interest expenditure pertaining to the Court ruling regarding interest compensation to repay deposit holders of Ljubljanska Banka and the capital injection of Soline have been considered one-off expenditure.

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Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and			
Current taxes on income,			
Capital taxes			
Social contributions			
Property Income			
Other			
Total			

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0	-0.3	-0.2
Intermediate consumption			
Social payments	0	-0.1	-0.1
Interest Expenditure			
Subsidies			
Gross fixed capital formation			
Capital transfers			
Other			
Total	0	-0.4	-0.3

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

3. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Slovenia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country specific recommendations in the area of public finances. Slovenia is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark.

Box 2. Council Recommendations[2] addressed to Slovenia

On 11 July 2017, the Council addressed recommendations to Slovenia in the context of the European Semester. In particular, in the area of public finances the Council recommended that Slovenia pursues a substantial fiscal effort in 2018 in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Slovenia's public finances.

The Council recalled that Slovenia is expected to further adjust towards an appropriate medium-term budgetary objective. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure which does not exceed 0.6 %. It would correspond to a structural adjustment of 1 % of GDP.

3.1. Compliance with the debt criterion

After the correction of its excessive deficit in 2015, Slovenia is in the transition period for the following three years. This implies that, during this period, it is required to make sufficient progress towards compliance with the debt reduction benchmark at the end of the transition period, as defined by the minimum linear structural adjustment (MLSA).

The DBP does not provide sufficient information to assess compliance with the minimum linear structural adjustment. Based on the Commission's 2017 autumn forecast, Slovenia is expected to make sufficient progress towards compliance with the debt reduction benchmark in both years. In 2017, Slovenia makes sufficient progress as the projected change in the structural balance (-0.1 % of GDP) is above the requirement (-1.3 % of GDP). The same applies to 2018, when the projected change in the structural balance (0.0 % of GDP) is again above the requirement (-3.1 % of GDP).

[2] OJ C 261, 9.8.2017.

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Table 5. Compliance with the debt criterion*

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	78.5	77.0	75.2	76.4	74.3	71.7	74.1
Gap to the debt benchmark [1,2]							
Structural adjustment [3]	0.1	0.6	0.0	-0.1	0.2	0.5	0.0
To be compared to:							
Required adjustment [4]	-0.7	-0.8	n.a.	-1.3	-3.3	n.a.	-3.1

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:
Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

* An ex-ante assessment of planned compliance with the debt criterion can be based on the DBP only for the concerned countries providing extended data series (i.e. covering years up to t+4) in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September 2014 and reflected in the updated Code of Conduct of the two-pack.

3.2. Compliance with the adjustment towards the MTO

In 2017, Slovenia was recommended to achieve a structural adjustment of 0.6 % of GDP. The expenditure benchmark pillar based on the Draft Budgetary Plan indicates compliance. By contrast, the change in the (recalculated) structural balance planned in the DBP points to a risk of a significant deviation, both over one year (deviation of 0.6 % of GDP) and two years (annual average deviation of 0.4 % of GDP). This calls for an overall assessment. The expenditure benchmark pillar is considered to appropriately reflect the underlying fiscal effort planned by Slovenia, while the reading of the fiscal effort based on the structural balance pillar is negatively impacted by large revenue shortfalls. Therefore, the DBP submitted by Slovenia is assessed to plan compliance with the requirements of the preventive arm in 2017.

According to the Commission autumn forecast, both the structural balance and the expenditure benchmark point to a risk of a significant deviation in 2017 (gap of 0.7% of GDP and 0.6% of GDP respectively). As indicated above, the expenditure benchmark pillar appears to more appropriately reflect the underlying fiscal effort of Slovenia. However, the expenditure benchmark is affected by the medium-term potential GDP growth rate used therein, which is much lower than the potential GDP growth rate emerging from the forecast for that year due to the large negative impact of the crisis years. At this stage, after taking into account into the expenditure benchmark the point estimate of potential growth of the

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Commission 2017 autumn forecast (i.e. 2.0 %), instead of medium-term potential growth (0.7 %), Slovenia would appear to be at risk of some deviation in 2017 (deviation of -0.1 % of GDP over both one year and on average over 2016-2017). This conclusion would not change in case the budgetary impact of the exceptional inflow of refugees was excluded from the assessment.

In 2018, the nominal growth rate of net primary government expenditure should not exceed 0.6 %, corresponding to an annual structural adjustment of 1.0% of GDP. The expenditure benchmark based on the Draft Budgetary Plan points to a risk of some deviation over 2018 (gap of 0.4 % of GDP) and over 2017 and 2018 taken together (average annual deviation of 0.2 % of GDP). At the same time, the (recalculated) structural balance planned in the DBP points to a risk of a significant deviation both in 2018 (gap of 0.5 % of GDP) and over 2017 and 2018 together (gap of 0.6 % of GDP). This calls for an overall assessment. Given that the structural balance continues to be negatively impacted by revenue shortfalls in 2018, the expenditure benchmark pillar is again considered to reflect more appropriately the underlying fiscal effort. Therefore, the DBP is assessed to plan a risk of some deviation from the requirements of the preventive arm in 2018.

According to the Commission's autumn forecast, both pillars point to a risk of a significant deviation (gap of 1.2 % and 1.0 % of GDP based on the expenditure benchmark and the structural balance respectively). Following an overall assessment, Slovenia is expected to be at risk of a significant deviation from the requirements of the preventive arm in 2018 according to the Commission 2017 autumn forecast.

However, the results from the plausibility tool concerning the Commission 2017 autumn forecast indicate that for Slovenia the output gap estimates appear to be counterintuitive. The implementation of the "constrained judgement" approach in the case of Slovenia (see Box 3) suggests that Slovenia could still be close to normal economic times in 2018, for which the matrix of requirements foresees an adjustment of 0.6 % of GDP.

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Box 3. Implementation of the "constrained judgement" approach and its impact on fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response, it was agreed, alongside a revision of the methodology for the estimation of the non-accelerating wage rate of unemployment, to introduce a "constrained judgement" approach for cases where the commonly agreed methodology appears to produce "counterintuitive" output gap results for individual Member States. This has already been implemented in the assessment of the 2017 Draft Budgetary Plans and the 2017 Stability and Convergence Programmes.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the common method. To this end, the Commission developed an objective screening tool - based on a set of cyclically relevant indicators as well as thresholds/ranges - to signal cases where the outcomes of the commonly agreed methodology could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. If this plausibility tool flags the estimate of a Member State's output gap using the common methodology, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

Regarding Slovenia, the plausibility tool provided indications that the output gap for 2017, estimated on the basis of the common methodology, may be counterintuitive. The output gap, as calculated on the basis of the commonly agreed methodology, is projected to turn positive in 2017 at 1.8 % of potential GDP (from -0.8 % in 2016) and reach 3.3% of potential GDP in 2018. The Commission estimates for the output gap are well above those of OECD (1.3 % in 2018) and IMF (0.6 % in 2018). The plausibility tool estimates the 2017 output gap at 0.2 %. The latter estimate indicates that the amount of idle capacities that are available for production (manufacturing capacity and labour force) may be higher than estimated on the basis of the production function method; however, the estimate can be also influenced by the relatively short time series.

Thus, while the output gap computed according to the commonly agreed methodology points to an output gap of 1.8 % of potential GDP, the estimate for 2017 calculated by the plausibility tool points to a significantly lower output gap 0.2 % of potential GDP. Reflecting the same 1.6 pps. of potential GDP difference into the 3.1 % (recalculated) output gap for 2018, based on DBP data, would lead to a positive output gap of 1.5 % of potential GDP next year. Slovenia is thus a borderline case and the uncertainties concerning Slovenia's cyclical position remain. This suggests that Slovenia could still be close to normal economic times in 2018, for which the matrix of requirements foresees an adjustment of 0.6 % of GDP.

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Table 6. Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.3		0.3	
Structural balance[2] (COM)	-1.5	-1.6		-1.6	
Structural balance based on freezing (COM)	-1.4	-1.5		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6	0.6		1.0	
Required adjustment corrected[5]	0.5	0.6		1.0	
Change in structural balance[6]	0.4	0.0	-0.1	0.5	0.0
One-year deviation from the required adjustment [7]	-0.2	-0.6	-0.7	-0.5	-1.0
Two-year average deviation from the required adjustment [7]	-0.1	-0.4	-0.4	-0.6	-0.9
Expenditure benchmark pillar					
Applicable reference rate[8]	-0.6	-0.7		0.6	
One-year deviation adjusted for one-offs [9]	0.0	0.1	-0.6	-0.4	-1.2
Two-year average deviation adjusted for one-offs [9]	0.0	0.0	-0.3	-0.2	-0.9
PER MEMORIAM: One-year deviation [10]	0.0	0.1	-0.7	-0.5	-1.1
PER MEMORIAM: Two-year average deviation [10]	0.0	0.0	-0.3	-0.2	-0.9
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Significant deviation	Overall assessment	Significant deviation
Conclusion over two years	Overall assessment	Overall assessment	Significant deviation	Overall assessment	Significant deviation

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

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The Commission Communication on the 2017 European Semester of May 2017[3] stated that the Commission stands ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment is particularly significant. The country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and the subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. Box 4 presents a qualitative assessment of the strength of the recovery in Slovenia while giving due consideration to its sustainability challenges.

Overall, Slovenia does not face short-term sustainability challenges, although in the medium term the overall risks to fiscal sustainability are assessed as high. The recovery in Slovenia does not appear fragile. Nonetheless, the fiscal adjustment of 1.0 % derived from the matrix may withdraw policy support abruptly and hamper economic growth and have too strong negative impact on economic growth in Slovenia, in particular for investment that remains below the pre-crisis levels. Moreover, the estimated output gap is subject to uncertainty as flagged by the plausibility tool.

Box 4. Assessment of the cyclical situation of Slovenia

Slovenia does not face short-term sustainability challenges. However, government debt is projected at around 76 % of GDP in 2017 and sustainability risks are considered to be high in the medium term, reflecting the high level of government debt and the projected ageing costs.

After having grown by 3.1 % in 2016, the Slovenian economy is strengthening further in 2017 (Commission 2017 Autumn forecast: 4.7 %). In the second quarter of 2017, GDP increased by 4.4 % year-on-year. Domestic demand increased thanks to the broad-based increase in investment and growing private consumption on the back of the increase in employment. Total employment increased by 2.8 % year on year. Core inflation averaged 0.8 % in the first seven months of 2017; however, due to the tightening labour market conditions, inflation is expected to accelerate to 1.8 % in 2018. At the same time, private investment remains below the historical and the euro area averages and is not expected to reach them in the coming years. The employment rate in 2017 remains below the pre-crisis level and the unemployment rate is still higher than before the crisis. In 2018, GDP growth is forecast at 4.0 %.

Overall, the recovery does not appear to be fragile. However, the estimated output gap is subject to uncertainty and the fiscal adjustment of 1.0 % derived from the matrix may withdraw policy support abruptly and hamper economic growth.

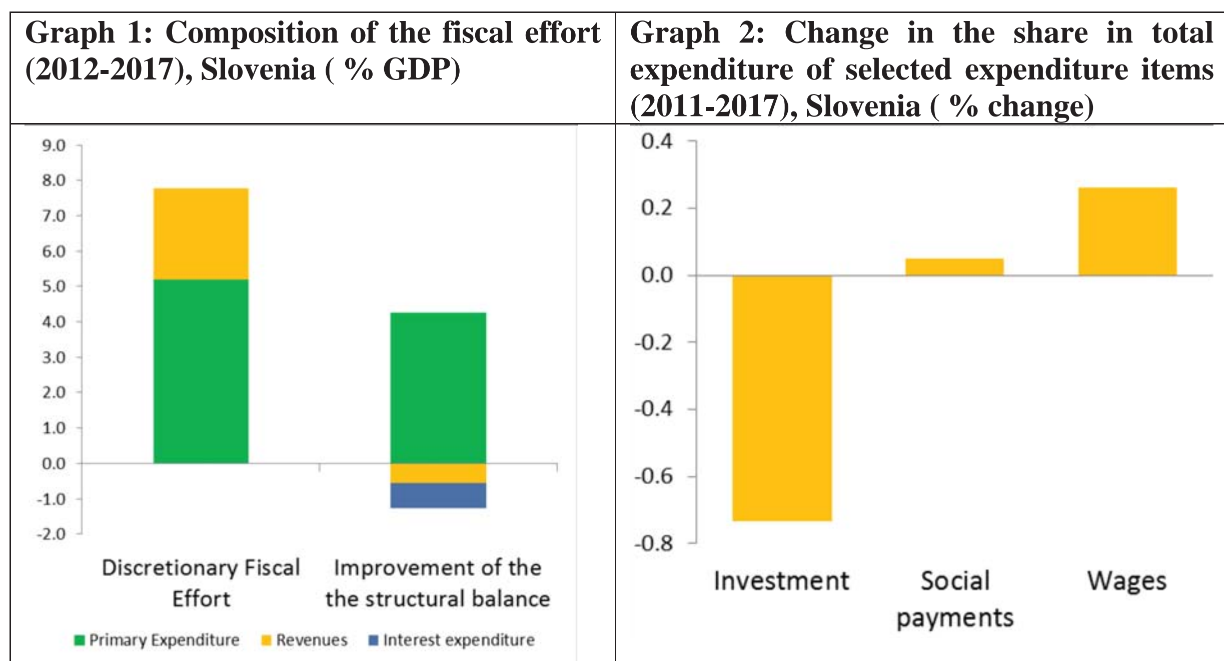
In order to balance the current stabilisation needs with the existing sustainability challenges, according to the Commission, a fiscal structural effort of at least 0.6 % of GDP is required, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary government expenditure not exceeding 1.5 %. Taking that into account in the overall assessment, Slovenia's fiscal adjustment cannot be considered adequate, in light of the sustainability challenges that Slovenia faces, on the basis of the Commission 2017 autumn forecast.

[3] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

4. Composition of public finances and Implementation of fiscal structural reforms

In 2018, both revenue and expenditure are expected to decrease relative to GDP (to 43.0 % of GDP and 42.6 % of GDP, respectively). In the aftermath of the crisis, several consolidation measures were taken both on the revenue and on the expenditure side. In Graph 1, these show up as the positive impact in terms of the discretionary fiscal effort. However, increased interest expenditure and revenue shortfalls weighted on the structural balance in the same period. In 2018, interest expenditure is planned to be substantially reduced.

After 2011, the share of investment in total government expenditure has decreased, while the share of social benefits and public wages has increased. The DBP plans a sizeable increase in public investment in 2018. Even though the DBP plans measures to constrain the growth of social payments and of the compensation of public employees, both items will continue to increase in nominal terms (though less rapidly than GDP), reaching 16.5 % of GDP and 11.0 % of GDP respectively in 2018.



Graph 1: Composition of the fiscal effort (2012-2017), Slovenia (% GDP)

Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Slovenia (% change)

Source:

Draft Budgetary Plans 2018, European Commission 2017 autumn forecast. Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

On 11 July 2017, the Council addressed recommendations to Slovenia in the context of the European Semester. In particular, with regard to the structural part of the fiscal recommendations the Council recommended Slovenia to adopt and implement the proposed reform of the healthcare system and to adopt the planned reform of long-term care, increasing cost-effectiveness, accessibility and quality care. The Council recommended Slovenia to fully tap the potential of centralised procurement in the health sector and adopt the necessary measures to ensure the long-term sustainability and adequacy of the pension system.

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According to the DBP, the health care reform is proceeding as recommended. The draft Health Care and Health Insurance Act, which contains the key elements of the reform, has been put to public consultation. The proposal addresses key issues, such as stabilisation of revenues and better quality and access of service provision. The stabilisation of revenues is planned to be achieved through the increased diversity of the financial resources and through financing some activities directly through the State Budget. Based on the DBP, action will be taken over the next two years to extend the mandatory joint public procurement to medical devices; however the measures have not been specified. In addition, the implementation of e-health solutions in healthcare continues.

The new law on long term care is planned to be submitted for public discussion in autumn 2017. The aim is to create an integrated long term care system with more emphasis on the formal home based care services, non-formal long term care services and services to support individuals to stay independent and in their homes longer. In the next two years, two pilot projects in two regions of Slovenia will be implemented to test and assess the new system. The law will be adapted to reflect the outcomes of the pilot projects.

In July 2017, the Economic and Social Council adopted measures for further development of the pension system in Slovenia. Agreed measures aim at ensuring the fiscal sustainability of the pension system and providing decent pensions.

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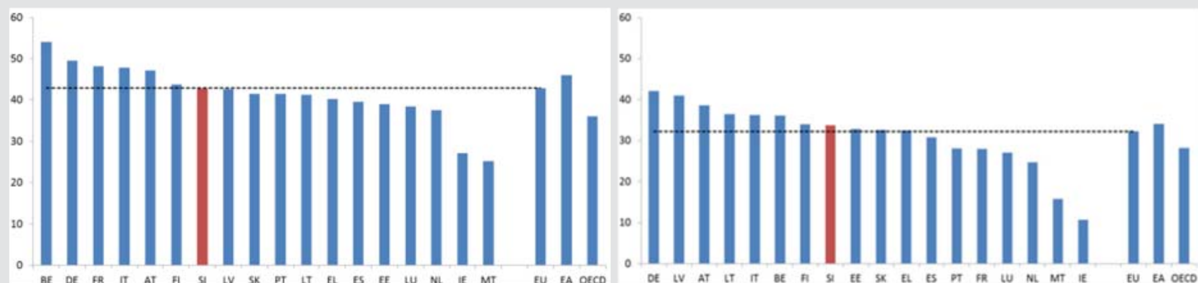
Box 5 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Slovenia for a single worker earning respectively the average wage and a low wage (50 % of the average) compared to the EU average.

The tax burden on labour in Slovenia at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth country-specific analysis is necessary before drawing policy conclusions.

Slovenia's Draft Budgetary plan does not include any measures that affect the tax wedge on labour.

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5. OVERALL CONCLUSION

On the basis of the Commission 2017 autumn forecast, the structural improvement in the debt-to-GDP ratio is in line with the minimum linear structural adjustment to ensure sufficient progress towards compliance with the debt criterion in 2017 and 2018.

Following an overall assessment of the draft budgetary plan, the planned structural adjustment is concluded to be in line with the required adjustment path towards the MTO in 2017, and at risk of some deviation in 2018. According to an overall assessment based on the Commission 2017 autumn forecast, there is a risk of some deviation from the adjustment path towards the MTO recommended by the Council in 2017 and a risk of a significant deviation in 2018. The conclusion for 2017 would not change in case the budgetary impact of the exceptional inflow of refugees was excluded from the assessment.

The planned structural adjustment for 2018 does not appear adequate even after taking into account the need to balance the two objectives of strengthening the ongoing recovery and ensuring fiscal sustainability that a large fiscal adjustment would have on Slovenia's ongoing recovery.

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