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Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Slovenia

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (TFEU) Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) On 2 December 2009, the Council decided, in accordance with Article 126(6) of the TFEU, that an excessive deficit existed in Slovenia and issued a recommendation[1] to correct the excessive deficit by 2013 at the latest, in accordance with Article 126(7) of the TFEU and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[2]. In order to bring the general government deficit below 3% of GDP in a credible and sustainable manner, the Slovenian authorities were recommended to implement the fiscal consolidation measures in 2010 as planned, ensure an average annual structural budgetary adjustment of ¾% of GDP over the period 2010-2013, and specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than expected at that time.

(4) On 15 June 2010, the Commission concluded that based on the Commission services' 2010 Spring Forecast, Slovenia had taken effective action in compliance with the Council recommendation of 2 December 2009 to bring its government deficit below the 3% of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary.

(5) According to Article 3(5) of Regulation (EC) No 1467/97, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) of the TFEU, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances

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[1] All documents related to the excessive deficit procedure of Slovenia can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/slovenia_en.htm

[2] OJ L 209, 2.8.1997, p. 6.

occur after the adoption of that recommendation. The occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the Council recommendation.

(6) In accordance with Article 126(7) of the TFEU and Article 3 of Council Regulation (EC) No 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of an excessive deficit to an end within a given period. The recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit. Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(7) On the basis of the Commission's 2013 in-depth review on Slovenia the Commission considers that Slovenia is experiencing excessive macroeconomic imbalances. Sustainable improvements in fiscal, macroeconomic and labour market outcomes require simultaneous progress in reducing macroeconomic imbalances and correcting the excessive deficit.

(8) The Commission services' 2009 Autumn Forecast, which was underlying the Council recommendation under Article 126(7) of the TFEU of 2 December 2009, projected that the Slovenian economy would expand by 1.3% in 2010 and 2.0% in 2011. The years 2012 and 2013 were beyond that forecast's horizon, but under the hypothesis of a gradual closure of the large negative output gap by 2015, higher growth than in 2011 was expected for 2012 and 2013. While GDP growth in 2010 was almost at par with that expected in the Commission services' 2009 Autumn Forecast, in 2011 it was below the projected 2.0%. The Slovenian economy slipped back into recession in 2012. The Commission services' updated 2013 Spring Forecast[3] implies a much more adverse scenario than the one foreseen at the time of the Council recommendation also for 2013. Overall, GDP growth turned out to be markedly lower than projected in the Commission services' 2009 Autumn Forecast. This is having adverse effects on both the revenue and expenditure sides compared to what was expected at the time of the Council recommendation.

(9) Slovenia has seen real GDP falling considerably more abruptly than in the euro area as a whole as a result of the global economic and financial crisis as well as domestic imbalances. The real GDP drop of 7.8% in 2009 was driven mainly by trends in gross capital formation. The export-led recovery Slovenia enjoyed in 2010 and 2011, when real GDP grew by 1.2% and 0.6%, respectively, was modest due to the drag from weak domestic demand. In 2012 the Slovenian economy slipped into a double dip recession with a negative real GDP growth of -2.3%. A positive contribution to growth from net external demand was a result of robust growth of export to non-EU markets and a sharp decline in imports due to weak domestic demand.

(10) The Commission services' updated 2013 Spring Forecast projects a further drop in real GDP by 2.0% in 2013 because of falling employment, negative real wage growth and a continued decline in investment. The deleveraging of non-financial corporations and

[3] This forecast is based on the Commission services' 2013 Spring Forecast, whose horizon has been extended to 2015. In addition, the update incorporates two bonds issued on the US market on 2 May 2013 with an impact on interest expenditure, deficit and debt.

rehabilitation of the banking sector are assumed to progress, but not yet sufficiently to support the start of a new investment cycle. Thus, private consumption and investment are forecast to remain the main drag on growth. The positive contribution to growth from net foreign demand is projected to slightly decline. The forecast continued recession with GDP growth of -0.1% in 2014 is a result of delays in resolving the banking crisis and restructuring the highly indebted corporate sector. Real GDP growth is projected at 1.3% in 2015 on the back of gradually strengthened domestic demand resulting mainly from a rehabilitation of the banking sector, progress in the deleveraging of corporations and improved consumer confidence.

(11) The general government deficit had soared to 6.2% of GDP in 2009 due to strong, in-built expenditure dynamics mainly of interest expenditure and social transfers. The largely ad-hoc consolidation measures in 2010 targeted lower growth of the public sector wage bill and social transfers in particular. The indexation of social benefit rates, including pensions, and of public sector wages was halved for 2010 and some work related bonuses were restrained. On the revenue side, excise duty rates on alcohol, cigarettes and mineral oils increased. These measures, approved before the adoption of the Council EDP recommendation, contributed to the slight reduction of the headline deficit in 2010 to 5.9% of GDP.

(12) The 2011 budget extended and strengthened the consolidation measures on the expenditure side from 2010 for mostly another year. On the revenue side, excise duty rates on cigarettes were further increased. Nonetheless, the headline deficit peaked at 6.4% of GDP in 2011 when capital support operations to loss-making state-owned enterprises and one-offs contributed 1.4% of GDP to the deficit.

(13) The March 2013 EDP notification as validated by the Commission (Eurostat) reported the 2012 general government deficit at 4.0% of GDP. This outturn covers another recapitalisation of the largest bank by some 0.2% of GDP in June 2012, being treated as one-off. The government implemented a major current expenditure restraint through cuts in public sector wages and social transfers. However, most consolidation measures are again valid only temporarily. In addition, public investment was reduced again, resulting in a drop totalling to 45% in real terms since 2009. Finally, capital injections, including one-offs, to public corporations were markedly lower than in 2011. On the revenue side, the government cut the corporate income tax rate and introduced more generous investment and R&D allowances.

(14) The Commission services' updated 2013 Spring Forecast projects the general government deficit in 2013 at 5.5% of GDP. However, without two one-off conversions of hybrid debt-equity instruments into equity of the two largest banks, amounting to 1.2% of GDP, the deficit for 2013 would be projected at 4.3% of GDP. The forecast deficit of 5.5% of GDP compares with the national deficit target for 2013 at 7.9% of GDP from the 2013 update of the stability programme, which includes recapitalisations of banks at 3.7% of GDP. Public finances in 2013 are expected to benefit from the full-year effects of savings measures in the Act on Balancing Public Finances, which entered into force in June 2012, and new approved revenue increasing measures from the 2013 budget. The worsening labour market is forecast to result in falling social contributions. By contrast, social transfers are projected to increase again because of a still high number of new pensioners at the end of 2012 and in early 2013.

(15) The Commission services' updated 2013 Spring Forecast projects the 2014 deficit at 4.9% of GDP under a no-policy change assumption. The 2014 budget does not incorporate new discretionary measures, except for a drop in the corporate income tax

rate to 16% and broad stabilisation of the public sector wage bill at the 2013 level. On the expenditure side, in particular interest expenditure and social transfers are projected to keep increasing because of higher debt, growing number of old-age pensioners and indexation of pensions. Under a no-policy change scenario, the deficit is projected at 5.5% of GDP in 2015. The forecast incorporates further increases in interest expenditure, higher public sector wage bill after the expiry of temporary measures curbing salaries of public sector employees and the final step of the gradual decrease in corporate income tax rate by 1 pp. to 15%.

(16) Excluding additional fiscal resources to strengthen banks, risks to the deficit projections seem balanced. Upside risks result from announced new savings measures in the 2013 supplementary budget, while downside risks stem from a weak budget implementation and the court judgement, still challenged by the government, stipulating the payment of the salary increase to public employees postponed in 2010.

(17) According to the Commission services' 2013 Spring Forecast the average annual fiscal effort taken at face value is estimated at 0.5% of GDP over the period 2010 – 2013. The consolidation was backloaded to 2012 and 2013. When adjusted for the impact of revisions in potential output growth between the current forecast and that underlying the Council recommendations of 2 December 2009 as well as for the impact of revenue developments as compared to those implied by standard elasticities, the average annual adjusted structural effort between 2010 and 2013 is estimated at 1.1% of GDP. This is above the recommended average annual fiscal effort of ¾% of GDP.

(18) The total amount of additional consolidation measures implemented by Slovenian authorities in response to the Council EDP recommendation over 2010-2013 is estimated at around 6¾% of GDP based on a bottom-up approach. This estimate excludes consolidation measures amounting to around 0.8% of GDP from the 2010 budget already included in the Commission services' 2009 Autumn Forecast. Measures amounting to some 5% of GDP have included in particular lowered indexation mechanisms and cuts in the public sector wages and social benefit rates as well as higher indirect taxes. In addition, the authorities significantly cut public investment by around 1¾% of GDP over 2010-2012.

(19) Slovenia faces steeply increasing public debt due to persistently large primary deficits and to a lesser extent stock-flow adjustments and higher interest payments. From as low as 22% of GDP in 2008, debt increased to 54% of GDP in 2012. The Commission services' updated 2013 Spring Forecast projects it to increase to 61% of GDP in 2013, thus breaching the Treaty reference value. Based on a no-policy-change scenario, debt is forecast to increase further to 69% of GDP in 2015. These projections do not include up to 11% of GDP of state guarantees for asset transfers to a Bank Asset Management Company and up to 3% of GDP of cash for recapitalisations as stipulated in the Banking Stability Act.

(20) Slovenia was hit with unexpected adverse economic developments. The economy is in a double dip recession projected to last into 2014. Employment has been affected negatively, unemployment has risen sharply and real wage growth became negative. Slovenia is also experiencing excessive macroeconomic imbalances which seriously hamper investment. Thus, domestic demand continues to decline. This is having adverse effects on both the revenue and expenditure sides compared to what was expected at the time of the Council recommendation. In line with the rules of the Stability and Growth Pact, this suggests that a new deadline for the correction of the excessive deficit in Slovenia by 2015 is appropriate.

(21) Granting two additional years for the correction of the excessive deficit would be commensurate with intermediate headline deficit targets of 4.9% of GDP for 2013 (3.7% of GDP without 1.2% of GDP one-off expenditure to recapitalise the two largest banks), 3.3% of GDP for 2014 and 2.5% of GDP for 2014. The underlying improvement in the structural budget balance implied by these targets is 0.7% of GDP in 2013, 0.5% of GDP in 2014 and 0.5% of GDP in 2015, the last two corresponding to the minimum improvement required by Article 5(1) of Council Regulation (EC) No 1466/97 of 7 July 1997. In total, to reach the above-mentioned structural targets, the Slovenian authorities would need to implement additional consolidation measures of 1% of GDP in 2013, 1½% of GDP in 2014 and 1½% of GDP in 2015 on top of the measures already included in the baseline scenario. These targets take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on GDP growth.

(22) The European Commission Fiscal Sustainability Report 2012 shows that Slovenia is at high sustainability risk in the medium and long term. The 2012 Ageing Report shows a high projected increase in total age-related public expenditure over the years 2010-60. To this end, additional containing of age-related expenditure growth by further adjusting all relevant parameters of the pension and social security systems appears necessary to contribute to the sustainability of public finances in the long term.

(23) Slovenia fulfils the conditions for the extension of the deadline for correcting the excessive general government deficit as laid out in Article 3(5) of Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure,

HAS ADOPTED THIS RECOMMENDATION:

(1) Slovenia should bring an end to the present excessive deficit situation by 2015.

(2) Slovenia should reach a headline general government deficit target of 4.9% of GDP in 2013 (3.7% of GDP without 1.2% of GDP one-off expenditure to recapitalise the two largest banks), 3.3% of GDP in 2014 and 2.5% of GDP in 2015, which is consistent with an annual improvement of the structural balance of 0.7% of GDP in 2013, 0.5% of GDP in 2014 and 0.5% of GDP in 2015, in order to bring the headline government deficit below the 3% of GDP threshold by 2015, based on the Commission services' updated 2013 Spring Forecast.

(3) Slovenia should rigorously implement the measures already adopted to increase mainly indirect tax revenue and reduce the public sector wage bill and social tranfers, while standing ready to complement them with additional measures if their yield would prove less than foreseen or if any measure is repealed by the justice system.

(4) In addition, Slovenia should specify, adopt and implement new structural consolidation measures, on top of those already included in the Commission services' updated 2013 Forecast that are necessary to achieve the correction of the excessive deficit by 2015.

(5) The Council establishes the deadline of [1 October 2013] for Slovenia to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Furthermore, the Slovenian authorities should (i) accelerate the reduction of the headline deficit in 2014 and 2015 if economic or budgetary conditions turn out better than currently expected; (ii) specify, adopt and implement structural consolidation measures which gradually decrease the current expenditure ratio to GDP, secure a lasting improvement in the general government structural balance, support growth potential of the economy including through avoiding further cuts in public investment, and gradually put the debt ratio on a downward path. Finally, to ensure the success of the fiscal consolidation strategy, it will be also important to back the fiscal consolidation by comprehensive structural reforms, in line with the Council recommendations addressed to Slovenia in the context of the European Semester and Macroeconomic Imbalances Procedure.

Beyond the report foreseen in recommendation (5), the Slovenian authorities should report on progress made in the implementation of these recommendations at least every [six months] as well as in a separate chapter in the stability programmes, until full correction of the excessive deficit has taken place.

This recommendation is addressed to the Republic of Slovenia.

Done at Brussels,

For the Council
The President