SUGGESTIONS FOR IMPLEMENTING THE LAW OF THE AMENDMENT TO ARTICLE 148 OF THE CONSTITUTION INTRODUCING A BALANCED BUDGET PROVISION

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Povzetek

Državni zbor je potrdil spremembo 148. člena ustave o srednjeročni uravnoteženosti javnih financ. Tako spremembo je treba operacionalizirati v izvedbenem zakonu.

Uravnoteženost proračuna se lahko opredeli glede na dejanski ali strukturni saldo. Pomanjkljivost definicije uravnoteženosti, ki temelji na strukturnem saldu, je njena odvisnost od tekočih ocen proizvodne vrzeli v dejanskem času, te pa so za Slovenijo izredno spremenljive. Standardni odklon ocen proizvodne vrzeli je do tri odstotne točke na leto, tako da se lahko fiskalno stanje, ki je bilo ex ante ocenjeno kot zaviralno, po objavi novih podatkov o stanju gospodarstva (ex post) spremeni v spodbujevalno. Takšno spremenljivost ocen je možno med drugim pojasniti tudi z dolžino časovne serije in vplivom napovedi na izračun proizvodne vrzeli. Če se zanašamo na sicer zelo spremenljive letne tekoče ocene proizvodne vrzeli, je lahko načrtovanje proračuna precej negotovo.

Spremenljivost tekočih ocen proizvodne vrzeli in posledična nezanesljivost njihove uporabe govori v prid opredelitvi fiskalnega pravila glede na dejanski saldo. Za ublažitev tveganja prociklične naravnanosti takšnega pravila pa je treba upoštevati tudi strukturni saldo in določiti zgornjo mejo strukturnega primanjkljaja kot sestavnega dela pravila. Prednost opredelitve pravila glede na dejanski saldo skupaj z najvišjim strukturnim primanjkljajem na ravni 0,5 % BDP je tudi večja transparentnost in odgovornost. Takšno pravilo je skladno s pravilom, opredeljenim v Pogodbi o stabilnosti, usklajevanju in upravljanju v ekonomski in monetarni uniji. Za zagotovitev predvidljivosti fiskalnih gibanj je treba uresničevanje pravila podkrepiti z večletnim finančnim okvirjem z obvezujočimi zgornjimi mejami nominalnih odhodkov.

Pojem »srednjeročno« v spremembi 148. člena se lahko razume kot določena časovna točka, od katere bo treba pravilo upoštevati ves čas, ali pa kot proces prilagajanja, ki bo potekal postopoma. Pomenski odtenek pri interpretaciji pojma »srednjeročno« ima pomembne posledice za fiskalno politiko in njen vpliv na gospodarsko aktivnost. Če pravilo določa, da mora biti proračun uravnotežen (tako glede na dejanski kot na strukturni saldo) od neke določene časovne točke naprej, to pomeni, da je od takrat naprej treba ravnovesje vzdrževati ves čas, razen v izjemnih okoliščinah. To pri definiciji ravnovesja glede na dejanski saldo izniči učinek proticiklične politike, pri definiciji glede na strukturni saldo pa ga omeji na avtomatsko stabilizacijo. Za razliko od tega pa definicija pravila uravnoteženih javnih financ (tako glede na dejanski kot glede na strukturni saldo), po kateri se ravnovesje doseže postopoma, omogoča določen manevrski prostor za proticiklično fiskalno politiko (do 0,5 % strukturnega primanjkljaja v skladu z evropsko zakonodajo).

Ne glede na definicijo uravnoteženega proračuna (glede na dejanski ali strukturni saldo) in interpretacijo srednjeročnega obdobja ima določitev časovne točke, ko bo pravilo o uravnoteženem proračunu postalo obvezujoče, pomembne politične posledice, saj bo sprejeto pravilo treba upoštevati oz. uresničevati. V času trenutne gospodarske recesije v Sloveniji (ki izpolnjuje pogoje za izredne razmere), pričakovanega šibkega okrevanja gospodarstva in velikega primanjkljaja (več kot 4 % BDP) bi realizacija pravila kratkoročno predstavljala za gospodarstvo velik šok, še posebej če bi pravilo o uravnoteženem proračunu (tako glede na dejanski kot glede na strukturni saldo) postalo obvezujoče npr. leta 2015. Pri tem je treba poudariti, da t. im. švicarski model fiskalnega pravila (naveden v Programu stabilnosti 2012 kot pravilo, ki bo uporabljeno v Sloveniji) zahteva, da je strukturni primanjkljaj uravnotežen ves čas. Ko bi takšno fiskalno pravilo stopilo v veljavo, bi bilo treba strukturno neravnovesje odpraviti takoj, kar bi v sedanjih okoliščinah predstavljalo velik in trajen šok za gospodarstvo.

Slabost opredelitve pravila o uravnoteženem proračunu glede na strukturni saldo (kar je teoretično sicer privlačno) je ocena proizvodne vrzeli v realnem času. Če bi bile ocene proizvodne vrzeli zanesljive, bi bilo glede na omejene instrumente ekonomske politike, ki so na voljo majhnim gospodarstvom, pravilo o strukturnem ravnovesju boljše opredeliti kot pravilo, ki se uresniči v določenem časovnem obdobju, vendar ne v vsakem posamičnem letu, saj je v tem primeru proticiklični učinek večji. Pri pravilu, ki zahteva stalno uravnoteženost, pa je proticiklični učinek omejen na avtomatski stabilizator.

Okoliščine, s katerimi se Slovenija sooča zdaj oz. s katerimi se bo soočala v srednjeročnem obdobju (vsaj do leta 2015), izpolnjujejo pogoje za izjemne razmere, v katerih se lahko od fiskalnega pravila začasno odstopi. Od leta 2015 naprej pa *bi proces prilagajanja pravilu potekal po postopku, v katerem bi bil določen čas (in trajanje) približevanja, kar govori v prid argumentu, da pravilo ne bi smelo postati obvezujoče prej kot leta 2017. Če povemo drugače: izvedbeni zakoni bi moral predpisati postopek za ugotavljanje časa prenehanja izjemnih okoliščin in dinamiko odpravljanja neravnovesja. V prehodnem obdobju pa bi bilo izvajanje fiskalne politike vezano na implicitna fiskalna pravila EU, ki vključujejo tudi finančne sankcije. Glede na sedanje ekonomske okoliščine Slovenija ne bi smela uvajati pravil, ki bi zahtevala hitrejšo prilagoditev, kot je določeno v predpisih EU.*

V primeru odstopanja od pravila, ki bi nastalo zaradi fiskalnega načrtovanja, je predviden samodejni popravljalni mehanizem, ki predvideva popravek neravnovesja v letu po nastopu teh okoliščin, kar je v skladu z zakonodajo EU.

Spremljanje skladnosti s pravilom in fiskalnim okvirjem je treba zaupati v ta namen ustanovljenemu parlamentarnemu uradu za nadzor proračuna oz. obstoječi instituciji, ki bi se ji povečala pooblastila. Ker spremljanje skladnosti ni enostavna naloga, je glede na pomembnost ocenjevanja cikličnih pogojev v večletnem okvirju pomembno, da se ustanovi takšen organ in natančno določi njegove pristojnosti in način upravljanja.

Ključne besede: *fiskalno pravilo, ocene proizvodne vrzeli v dejanskem času, proticiklična politika, izjemne okoliščine*

Abstract

The aim of this paper is to contribute to the design of implementing the law of the changes to Article 148 of the constitution endorsing a balanced budget provision. It does so taking into account: a) the existing legal constraints derived from the Stability Growth Pact (SGP); b) the country-specific recommendations to Slovenia resulting from the Excessive Deficit Procedure (EDP); c) the current economic conditions in Slovenia and the effect of the fiscal policy on them; d) the impact of the banking sector's balance sheet strengthening on the fiscal position and; e) the policy setup including the absence of an independent monetary policy. The paper provides concrete suggestions on how to make the amendment to Article 148 operational in the implementing law. In particular it proposes: the fiscal rule to be observed (i.e. balanced headline budget rule with a maximum structural deficit); the time frame for making it binding (i.e. from 2017 onwards or when the output gap will be closed); the conditions qualifying as exceptions to the rule (i.e. exceptional circumstances as defined in line with EU legislation); the procedure for converging from exceptional circumstances to a balanced budget position; an automatic correction mechanism dealing with slippages due to over-optimistic fiscal projections or output gap estimates; and the institutional setup for monitoring the fiscal rule-based framework (i.e. by creating a Parliamentary Budget Office or entrusting such a responsibility to an existing institution).

Key words: *Fiscal rule, real-time output gap estimates, countercyclical policy, exceptional circumstances*

Introduction

This paper provides concrete suggestions as to how to implement the amendment of article 148 of the constitution. The suggestions are made taking into account: a) existing legal constraints derived from the Stability Growth Pact (SGP); b) country specific recommendations to Slovenia resulting from the Excessive Deficit Procedure (EDP); c) current economic conditions in Slovenia and the effect of the fiscal policy on them; d) the impact of the banking sector's balance sheet strengthening on fiscal position; and the policy set up including the absence of an independent monetary policy.

Section 1 summarises the amendments to article 148 of the Constitution. Sections 2 and 3 discuss the EU legal framework and recommendations derived from the excessive deficit procedure constraining the fiscal policy in Slovenia. Section 4 deals with the impact of the fiscal policy on economic activity and the issue of using output gap estimates in real time for formulating fiscal policy. Section 5 assesses the fiscal projections as detailed in the Stability Program 2013 as the basis for implementing any fiscal rule. Section 6 and 7 provide suggestions as to how the balanced budget rule should be framed and when it should become binding (i.e. the concept of medium term). Section 8 provides interpretation to the notion of exceptional circumstances and provides suggestions about the procedure of convergence to a balanced budget position once exceptional conditions cease. In addition, it proposes an automatic correction mechanism for dealing with fiscal planning and the institutional set up for monitoring compliance with the rule. The last section presents conclusions.

1. The approved changes to article 148 of the constitution and the issues to be defined

The parliament endorsed changes to Article 148 of the Constitution dealing with public finances. They require that the revenue and expenditure of the government should be balanced or in surplus over the medium term. It also foresees exceptions to this "constitutional fiscal rule" under the so-called exceptional circumstances concept which should be defined in conformity with those agreed in the SGP. According to the SGP they include: national catastrophes or unusual events outside the control of the concerned member state with a major impact on the financial position of the general government, or periods of severe economic downturn as defined in the SGP, including at the level of the euro area.

A separate implementing law of the amendment to Article 148 shall be adopted by the parliament with two-thirds majority which shall define the meaning of: i) "balance between revenue and expenditure"; ii) the notion of "medium term" and; iii) the concept of "exceptional circumstances". The implementing law could or will also define how the "balance between revenue and expenditure" will be achieved and maintained (i.e. automatic correction mechanism or additional constrains or rules).

The agreement reached by political parties that are members of the parliament indicates that the "constitutional fiscal rule" and the implementing law will first be applied in the drafting of the 2015 budget. The key question in this regard is the meaning of the notion "to first be applied in the drafting of the 2015 budget". It is not clear whether: a) the public finances will be in balanced by then; b) in which sense public finances will be balanced (headline or structural deficit) and; c) when if not in 2015 will the public finances be balanced. These issues are addressed below.

2. The fiscal framework and policy making in Slovenia is constrained by endorsed stability and growth pact fiscal rules

The Slovenian fiscal policy is not made alone or in a vacuum. Sovereignty in fiscal policy matters is constrained by subscribed EU fiscal policy legislation and rules. Those rules are of a binding nature and it is demanded that they should be transposed into national legislation. The fundamental issue is how to make their transposition into national legislation optimal to avoid complexity, lack of transparency, duplicity, impose unnecessary constraints to economic activity and provide enough room for a countercyclical policy within the automaticity environment of fiscal rules.

The Slovenian parliament upon request of the government endorsed in 2011 the so-called "six-pack" (secondary legislation) as well as the Treaty on Stability, Coordination and Governance (TSCG) (intergovernmental agreement (not EU law)[1]. Thus, the fiscal policy in Slovenia is abided by the set of EU fiscal rules and respective sanctions in case of nonadherence ("six pack"). Slovenia is obliged by those legal acts to transpose into national legislation the underlying endorsed EU fiscal rules. Furthermore, the European Court of Justice will verify transposition of the EU fiscal rules in national legislation[2].

The Slovene parliament endorsed EU fiscal rules demanding from Slovenia not only the elimination of the headline fiscal deficit (i.e. the difference between general government's revenue and expenditure as defined according to ESA 95 methodology), but also the permanent generation of fiscal surpluses. Member states are abided to implement in their national legislation the concept of structural balance (i.e. government budgetary position in balance or surplus excluding the impact of the economic cycle and one-off and temporary measures) and are demanded to set and attain a country-specific medium term objective (MTO) (i.e. a budgetary position defined in structural terms taking into account: the fiscal challenge posed by population ageing; their size of gross government debt and a safety margin against breaching the 3% of GDP deficit reference value). This in the case of Slovenia implies the generation of a surplus in the government headline accounts[3].

The fiscal legislation in the "six-pack" and TSCG overlap but the latter is more stringent with respect to three aspects: a) it requires member states to enshrine into national legislation (preferably the constitution) the rule that government accounts (i.e. net borrowing position) should be balanced with a maximum structural deficit of 0.5% of GDP and include an automatic correction mechanism;[4, 5] b) foresees an automatic correction mechanism at a EU level to ensure that action is undertaken by the member state in case of deviation from its MTO or the adjustment path towards it[6, 7]; and c) provides more weight to the EU Commission when issuing recommendations regarding each stage of

[1] For a details see http://eur-lex.europa.eu/JOHtml.do?uri=OJ%3AL%3A2011%3A306%3ASOM%3AEN%3AHTML
http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

[2] The European Court of Justice (ECJ) will verify transposition of structural balance rule in national legislation and may impose a financial sanction (0.1% of GDP) if a country does not properly implement the new budget rules in national law and fails to comply with a ECJ.

[3] Caprirolo C. "Policy formulation during fiscal consolidation and beyond under the strengthened EU fiscal framework "(six pack and Treaty on Stability, Coordination and Governance (TSCG)" UMAR mimeo 2012 April

[4] Countries need to establish automatic correction mechanisms at the national level in the event of deviations from the rules.

[5] Compliance with the rule in national law will have to be monitored at the national level by independent institutions.

[6] Escape clauses are envisaged for exceptional circumstances.

[7] The already introduced six-pack financial sanctions for "euro-area Member States", concerning non-compliance with the preventive arm to the latest stages of the EDP. Sanctions are imposed gradually and may reach up to 0.5% of GDP

the excessive deficit procedure (EDP) against a given member state which could only be reversed in cases of reverse qualified majority voting (i.e. automaticity of the EDP procedure).[8, 9]

The enhanced EU fiscal framework currently in place can be conceived as a set of fiscal rules, correction mechanisms and sanctions steering fiscal action towards achieving and maintaining budget balances or surpluses defined in structural terms with maximum allowed country specific structural deficits. The set of fiscal rules concern the process of correcting excessive deficit and debt positions (i.e. headline deficit above 3% of GDP and gross debt above 60% of GDP), convergence to structural balance positions and prevention and correction of deviation from the MTO. The specific rules that Slovenia and other member states are abided to observe are the following: i) reducing deficits and debt levels in excess of 3% of GDP and 60% of GDP respectively in a given time frame; ii) ensuring a minimum consolidation speed towards the MTO defined as a benchmark reduction of structural deficit of 0.5% of GDP when deficits are below 3% or 1% structural deficit reduction when debt is above 60% of GDP; and iii) achieving a country specific MTO and observing it permanently as the overarching fiscal rule including an automatic correction mechanism and a permanent rule constraining the government's expenditure growth to the maximum given by the average growth of the nominal potential output.[10]

Based on EU fiscal framework and provided that the clause of exceptional circumstances is not invoked by the government (i.e. severe economic downturn) it is possible to determine for Slovenia a maximum time for full compliance with the fiscal rules (i.e. the transition from excessive deficit position to budget deficit elimination) without being subject to financial penalties. A more ambitious fiscal policy would ensure earlier compliance with the EU rules.

The implicit maximum time frame for compliance with the fiscal rules and thus elimination of the structural deficit can be estimated by taking into account the 2012 fiscal position in 5 years (2013-2017) depending on output gap estimates and fiscal effort considering the following three phases: 1) reduction of the current government deficit below 3% by 2015 (i.e. 3 years); 2) reduction of the structural deficit by at least 0.5% of GDP annually until achieving the MTO in two years (i.e. with yearly current deficit reduction exceeding the reduction of the negative output gap or lower reduction of the headline deficit when widening the negative output gap).[11]; 3) Permanent adherence to the MTO's (2017 onwards). Notice however, that the maximum time frame for reaching the MTO could be shorter if the EU Commission deems this appropriate and there is no opposition by the EU Council.

3. European commission's EDP's country specific recommendations to Slovenia

Besides the rules of the EU strengthened fiscal framework, Slovenia's fiscal policy is abided by annual EU Council country specific recommendations prepared by the European Commission (EC). EC recommendations are binding in the absence of opposition from the EU Council. These recommendations are provided in the context of the EU fiscal semester and are aimed in the case of Slovenia at correcting the excessive deficit procedure and attaining the MTO. The EC recommendations published in May 2013 and endorsed by the Council set fiscal targets for Slovenia not only for the government headline deficit but also for the structural deficits for the period 2013-2015 as follows: "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."[12]

The EC recommendations mean that regardless of whatever domestic fiscal rule is in place in Slovenia, the fiscal policy in the period 2013-2015 is going to be assessed and eventually sanctioned according to EC recommendations. Therefore, looking at the EC structural budget targets for the period 2013-2015, it is clear that the de facto underlying fiscal rule that Slovenia has to observe in the period 2013-2017 is the reduction of the structural deficit by at least 0.5% of GDP every year.

The envisaged fiscal policy targets of the government as stated in the Stability Program update 2013 (SP13) can be compared with those recommended by the EC against different dynamics of the change in output gap. The targets of the EC are more frontloaded in 2013 and the headline deficit reduction dynamic for the period

[8] It implies that a recommendation or a proposal of the Commission is considered adopted in the Council unless a qualified majority of Member States votes against it

[9] The TSCG also sets to introduce concrete procedures for reinforced surveillance and coordination of economic policies (e.g. ex-ante coordination of debt issuance plans),

[10] Average potential GDP growth rates of the previous 5 years, the estimate for the current year and the projections for the following 4 years

[11] For example, the minimum consolidation speed (i.e. 0.5% structural deficit reduction per year) under a zero output gap and a 3% of GDP deficit starting position implies reaching the MTO in at most 6 years. Alternatively, the minimum consolidation speed with starting conditions of a negative output gap of 3% closing by 1 p.p. per year and a deficit of 3% of GDP would imply reaching the MTO in at most 4 years

[12] http://europa.eu/rapid/press-release_MEMO-13-463_en.htm

2014-2015 is set to ensure a minimum 0.5% reduction of structural balance. The targets in the SP13 place the bulk of the fiscal effort in 2014. On average the fiscal effort is stronger in the SP13 compared to that recommended by the EC for the period 2013-2015. Two questions are relevant to this comparison: 1) what is the true output gap? and; 2) what is the real binding fiscal target or fiscal rule Slovenia has to observe going forward? These questions are addressed below.

4. Impact of fiscal consolidation on economic activity and reliability of output gap estimates in real time to be taken into account when formulating fiscal rules

In order to assess fiscal policy, its targets and eventual rules are of utmost importance to consider the effect of the fiscal policy on economic activity. Similarly important is the reliability of output gap estimates in real time. This is because the EU fiscal framework relies on the concept of structural balance and eventually fiscal rules in Slovenia had to take into account the effect of the business cycle and one-off types of transactions in measuring the fiscal stance. Output gap estimates are particularly relevant given that budget planning requires predictability and stability.

Assessing the impact of consolidation in the economy does not mean that no consolidation policy is the alternative option, yet it is important to internalise in the policy formulating process and framing of the fiscal rule the effect of fast versus slow consolidation as both strategies can be self-defeating. A sharp consolidation can further deepen economic recession lowering employment and revenue, causing budget targets to be missed and raise the debt-to-GDP ratio. On the other hand, slow consolidation can question the credibility of the process and raise interest payments crowding out expenditure and raising debt. Thus the issue is clearly how to anchor fiscal consolidation policies in a credible strategy over the medium-term in which the quality (sustainability of measures and impact on GDP) is of outmost importance.

The literature on the assessment of the effect of fiscal policies in the Slovene economy is limited. Jemec et.al (2013) using quarterly data for the period 1995-2010 and a structural VAR approach assessed the dynamic effects of fiscal policies on macroeconomic developments in Slovenia. In particular they estimated fiscal multipliers for temporary shocks. Caprirolo and Glažar (2013) based on DSGM estimated fiscal multipliers for temporary and permanent shocks assessed the 2012 Stability Program's fiscal policies strategy on economic growth. Both studies found that expenditure multipliers are relatively larger than indirect tax multipliers in line with the bulk of the literature on the subject (Baum et.al 2012).

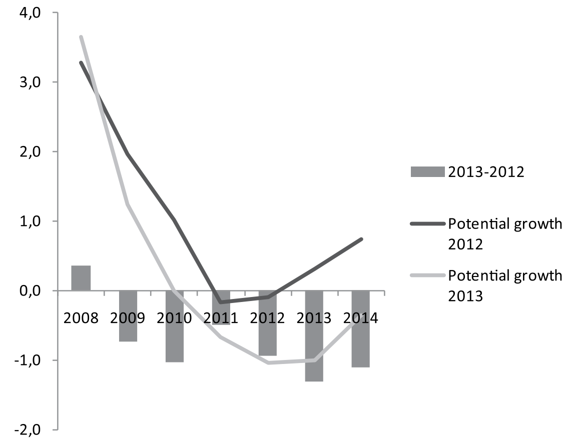
Evaluating the effect of a fiscal policy is not simple and its impact on the economy is not symmetrical with larger stronger multipliers in recessions than in normal times (Blanchard and Leigh 2013). Similarly, empirical evidence has become richer with the recent consolidation process over the previous two years. In particular, in Slovenia's recent history (2000-2012) there were no significant negative government expenditure shocks (i.e. nominal reduction in government expenditure without one-off transactions or negative changes in cyclically adjusted expenditure without one-offs as a percentage of GDP) with the exception of those experienced in 2012. In the case of large positive expenditure shocks, the one in 2008 seems to be a clear outlier.

Notwithstanding the difficulties in coming out with an exact assessment of the impact of consolidation on economic activity and because of its relevance for formulating and designing the fiscal policy, the impact of the 2012 fiscal consolidation on the economy was assessed based on the multipliers estimated by Caprirolo and Glažar (2013). In this context it is important to highlight that the economy is undergoing multiple shocks. In particular the financial system is under stress and imposing tighter credit constraints. This causes consumption to depend more on current than on future income as well as investment to depend on current rather than on future profit. These issues argue for large fiscal multipliers. Nevertheless, based on the estimated multipliers the impact of the reduction of various expenditure categories (government consumption, social transfers and investment) in 2012 totalling 1.8% of the 2011 GDP is estimated to have had a negative impact on the rate of real GDP growth (YoY%) of a magnitude between 1 p.p. and 1.3 p.p. depending on the share of liquidity constrained individuals whose current consumption is determined by current income. The effect of the consolidation on the debt-to-GDP ratio including the multiplier effect on GDP seems positive. Nevertheless, in a deflationary environment the impact of consolidation on the debt ratio can be negative.

The other important issue to disentangle is the impact of fiscal consolidation on the estimates of output gap. Fiscal shocks affect GDP and potential growth (as measured by the smoothed GDP series) and both inputs used in the measurement of output gap. Output gap estimates are relevant for calculating the so-called observed structural balance, which is the benchmark to measure fiscal policy effort under the EDP procedure and in the convergence to the MTO.

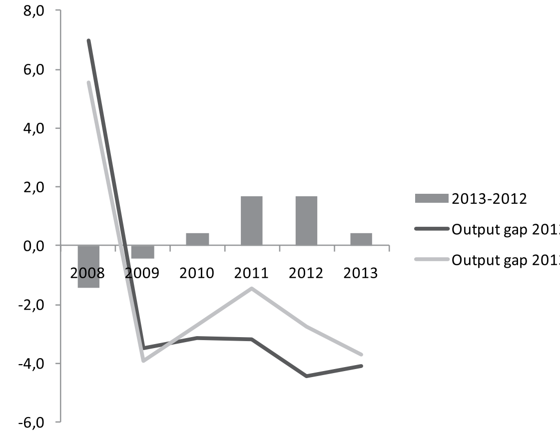
As a primary approximation towards assessing the effect of fiscal consolidation on economic activity, the EC 2012 and 2013 forecasts of GDP growth and estimates of potential output and output gap can be compared. The EC 2012 forecast foresaw a GDP growth

Figure 1: **European Commission estimates of potential growth, yoy%**



Source: European Commission.

Figure 2: **European Commission estimates of output gap (% potential output)**



Source: European Commission.

rate for 2012 higher than the actual rate as well as a higher GDP growth rate for 2013 compared to that in the most recent forecast (2013). Consequently, the 2013 revised potential growth rate for 2012 is lower than that envisaged in 2012. But, not only that, the 2013 revised potential growth rates for the entire period 2009-2014 are lower than estimated in 2012 (Figure 1).

The impact of the revised GDP forecast and potential output is reflected in the estimates of the output gap in Figure 2. Comparing real time or ex-ante (2012) and ex-post (2013) estimates of these indicators for 2012 suggest the following: i) in 2012 it envisaged a low negative impact of the shock on GDP growth rate but stronger impact on the negative output gap. Based on the 2013 estimates, the negative impact of the shock on GDP growth was stronger while that on output gap was milder (lower by 2 p.p.) due to ex-post lower potential growth estimates (i.e. this magnified the size of fiscal effort in that year but reduced the impact of shock on economic activity as captured by the output gap but not on actual GDP growth rate); and ii) the negative shock set the ex-post output gap on a widening negative trend for the near future which was not envisaged in 2012 (i.e. more negative slope). Therefore, looking ex-post at dvelopments sizable negative shocks to GDP (ceteris paribus) seem to manifest in lower GDP growth and potential growth rate estimates at the time of the shock compresing and not widening the output gap(Figure 1), but lower and widening output gap in the years following the shock (Figure 2).

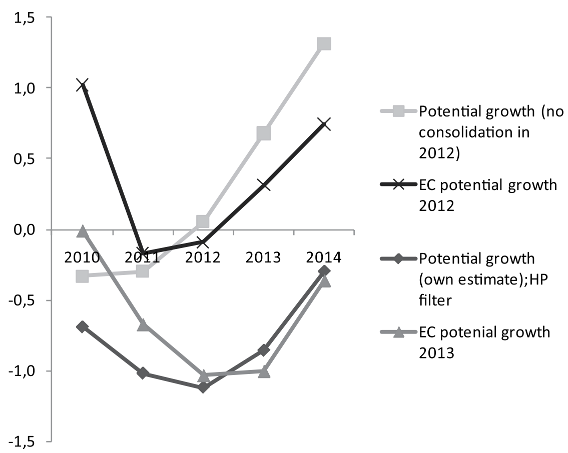
In assessing the impact of fiscal shocks on the economy (i.e. GDP, potential output and output gap), the estimated impact of the fiscal policy shock in 2012 by Caprirolo and Glažar (2013) is used (i.e. 1.p.p. lower GDP growth rate brought by 1.8% of GDP expenditure reduction). With this information the counterfactual of GDP growth rate that the economy would have had in 2012, if consolidation would not have taken place, is simulated. This is done by subtracting the effect of the fiscal shock on actual GDP growth rate in 2012 and then estimating the counterfactual potential output and output gap for the period 2013-2016 taking into account the 2012 UMAR's spring forecast for GDP growth.[13]

Figure 3 shows the potential growth rate the economy would have experienced in 2012 if the fiscal shock would not have taken place (red line). The potential growth rates are not significantly different from those estimated by the EC in April 2012, but the potential growth's positive slope is steeper. Figure 3 also shows the EC 2013 revised potential growth estimate is not substantially different from own estimates based on the HP filter. Figure 4 shows that under no consolidation scenario the negative output gap in 2012 would have been wider (as it is also the case in Figure 2) but then the output gap would have closed faster which is not the case under the consolidation scenario where the output gap widens in the years after the shock (Figures 2 and 4).

Based on the simulation, it can be said tentatively that sizable negative fiscal shocks reduce potential growth estimates narrowing with it the output gap at the time when the shock takes place but widening the output gap in the following years and thus postponing the closing of the output gap. The implication for policy formulation going forward is that negative fiscal shocks, ceteris paribus, tend to adversely affect GDP (i.e. 1% of GDP lower expenditure leading to at least a 0.5% lower growth of GDP) and potential growth trends estimates in the short to medium term. The effect of fiscal shocks on the measurement of fiscal effort in itself (i.e. change

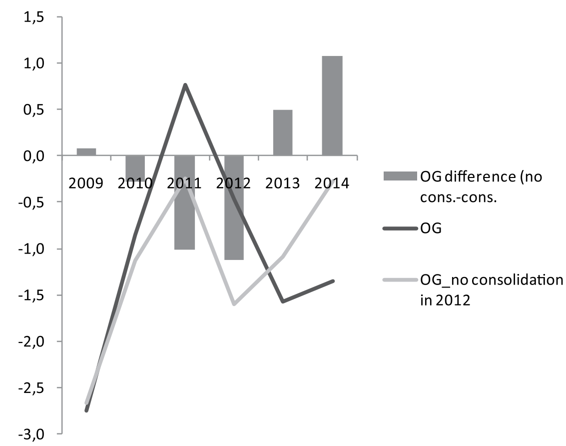
[13] Notice that in theory, demand shocks should not have an effect on potential growth, particularly in the long-term, but according to the methodology of measuring potential output, changes in demand affecting GDP also affects potential growth.

Figure 3: **Potential growth simulation w/wo consolidation in 2012, yoy%**



Source: European Commission, own estimates.

Figure 4: **Simulation of output gap (OG) w/wo consolidation in 2012 (% potential growth)**



Source: European Commission, own estimates.

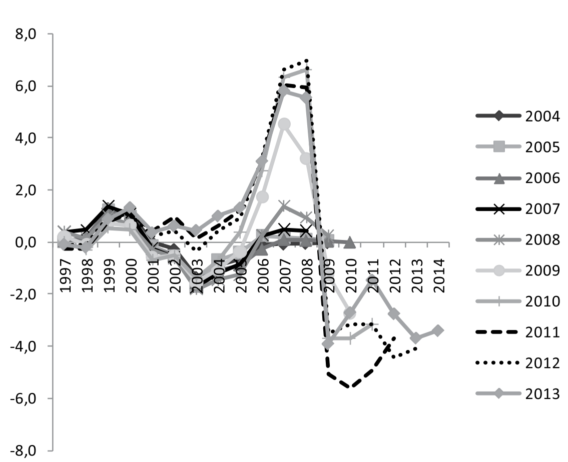
in structural balance) at the time of their occurance is to magnify it as it narrows the output gap, but the impaction output gap is visible in the following years.

Taking into account the information concerning deficit, structural balance and output gap in the stability programs of 2012 (SP12) and 2013 (SP13), it is possible to disentangle the underlying composition of structural balance and discuss possible interaction with economic developments. While the fiscal effort (i.e. change in structural balance) is the same in the SP12 and SP13, their determinants are different. The SP12 envisaged a slightly larger deficit reduction and substantially smaller change in the negative output gap while the SP13 reports lower actual deficit reduction but, despite a smaller output gap, a larger negative change in the output gap to which fiscal consolidation contributed.

This suggests that it is feasible to achieve a given fiscal effort during consolidation but to some extent this is possible at the expense of lower growth or that the fiscal effort is magnified by lower growth. Since there is no linear relationship among variables the question is also the feedback effect of lower growth on revenue and on the fiscal targets themselves which could be further analysed in the context of a general equilibrium model.

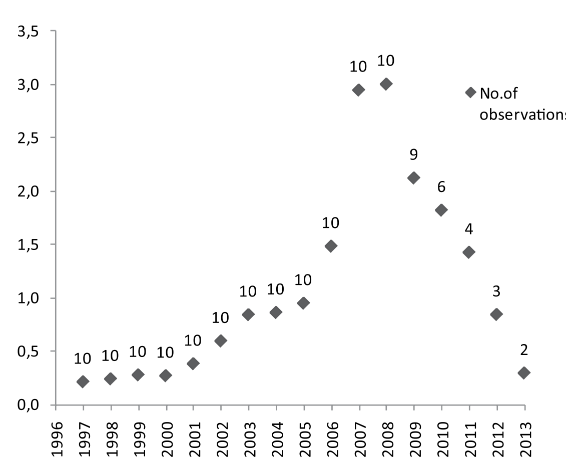
Since the EU fiscal framework relies on the concept of structural balance and Slovenia in designing its fiscal rule it is obliged to limit the structural deficit to a maximum of 0.5% of GDP, a key issue is to assess the implications of the volatile potential growth and output gap estimates in real time for formulating fiscal rules or achieving fiscal targets. Following Caprirolo (2012), Figures 5 and 6 show the annual output gap estimates

Figure 5: **European Commission's estimates of Slovenia's output gap (% potential output)**



Source: European Commission.

Figure 6: **European Commission's estimates of Slovenia's output gap (standard deviation)**



Source: European Commission, own calculation.

for Slovenia made in real time by the EC each spring since 2004 and the standard deviation of those estimates for each single year. Figure 5 suggests a wide variability of output gap estimates not only for a given year, but more recent estimates (2011-2013) indicate that the output gap estimates for the period 2001-2006 instead of being negative as previously estimated they are zero (i.e. no output gap) or positive which implies a revision of the recent economic history of Slovenia. Figure 6 also provides an idea of the huge variability of output gap estimates. For example the standard deviation of the output gap estimates for the years 2007 and 2008 is 3%. This implies that an ex-ante fiscal position of structural surplus of 3% of GDP can be revised ex-post to just a balance position. The implication of the output gap variability for budget formulation will be to make expenditure planning quite erratic. Particularly, this would be the case if budget formulation is not anchored in a medium term framework.

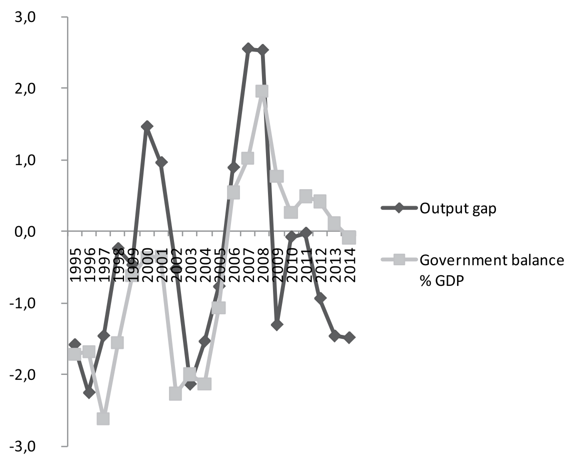
The volatility of output gap estimates has important implications for estimating structural balances and compliance with a fiscal rule based on it. To ensure credibility and to avoid breaching national and EU laws, it might be necessary to either set a safety margin around the rule (i.e. pursuance of structural surplus) and carefully craft the fiscal correction mechanism or alternatively the rule should make explicit reference to a maximum structural deficit of 0.5% of GDP to cater for the uncertainty of measurement of output gap but also to provide room for the countercyclical policy discussed below. Choosing between options can have implications for economic activity as it implies taking a stance against both phases of the business cycle and requires a different fiscal effort which is an important dimension under current conditions.

5. Government envisaged fiscal policy for the period 2013-2017 as the baseline scenario for assessing fiscal rules and compliance

Fiscal policy is not made without reference to economic circumstances. That is why even fiscal rules have exceptions. Therefore overall economic conditions, available policy tools and constraints as well as the interaction between fiscal policy and economic activity should be considered when deciding on the fiscal framework. In particular Slovenia is facing the unwinding of leverage positions of corporate sector and banks' balance sheets which constrains aggregate demand amidst massive capital outflows. Similarly, the crisis in the euro area is reflected in low external demand limiting the strength of the recovery. Fiscal consolidation is not only contributing to restrain aggregate demand directly but indirectly by affecting the behaviour of households (i.e. confidence). Slovenia does not have an independent monetary policy and private agents are facing higher interest rates than counterparties in other euro area countries. Unlike large countries that can have a rule based fiscal policy and enjoyed the benefits of an anti-cyclical monetary policy (i.e. independent monetary policy or large countries within a monetary union) this possibility is more limited in the case of smaller countries. Also the application of rules and policy measures at the EU level can be asymmetrical to small countries such as the intervention in bond markets when government yields sharply increase and in the application of standards that can weaken the implementation of swift policy measures to tackle key challenges as for example the process of cleaning banks' balance sheets to steer recovery. Substantially higher government's bond yields in the case of Slovenia compared to Spain might also reflect these conditions. Excessive fiscal contraction in such an environment can hamper economic recovery and push further enterprises out of business and could lead to a self-defeating strategy.

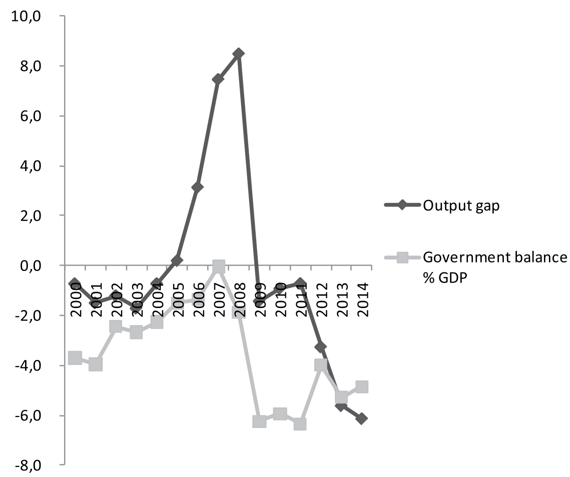
Based on these considerations, the design of the implementing law of the parliamentary endorsed fiscal rule should be based on the most recent fiscal projections and targets made in SP13 and the risks associated with its implementation. While it is straightforward to estimate a fiscal rule based on a given projection of economic activity and derive a path for a given fiscal aggregate, such an exercise will be incomplete or futile if it is not accompanied by an assessment of the fiscal implications of introducing the rule on economic activity and its feedback on the fiscal stance. This is particularly relevant when considering the time frame for making the rule binding. For example the timeframe for binding the German fiscal rule (German Ministry of Finance, 2012), which is similar to that of Switzerland, is 7 years (2016) for the federal government and 11 years for the states (2020). It was also envisaged a gradual move towards structural balance in 2011, 2 years after its approval when economic recovery was clearly foreseen (real GDP growth rate above 1.5% annually). The case of Spain is another example of considering background economic conditions in deciding when to make the fiscal rule binding. The Spanish Constitution amended in 2011 included a fiscal rule demanding structural balance or surplus becoming binding from 2020 onwards (i.e. 9 years for implementation). The success in implementing a rule also depends on the underlying conditions. For example the relative success of the implementation of the Swiss fiscal rule "debt brake rule" has to be seen in the context of the economic conditions and supporting policy instruments (i.e. independent monetary policy). In 1998, a constitutional "balance budget target for 2001" was introduced in order to eliminate the structural deficit and the debt brake was introduced in 2003. Yet, the bursting of the dotcom bubble complicated policy implementation, requiring additional policy measures (Figure 7) (i.e. a consolidation plan in 2003 ("EP 03") followed by a set of measures in 2004 ("EP 04"). With the Swiss economy recovering, the implementation of the rule in the second half of the past decade seems to have been satisfactory. For comparison to the Swiss case (Figure 7), Figure 8 shows the government balance

Figure 7: **Switzerland, government balance and output gap**



Source: OECD.

Figure 8: **Slovenia, government balance and output gap**



Source: European Commission.

and output gap figures for Slovenia. The difference in size of the ex-post output gap estimates in the phases of boom and the bust of the cycle between countries is particularly striking (e.g. the positive output gap in Switzerland is lower than 3% while in Slovenia reaches up to 9%).

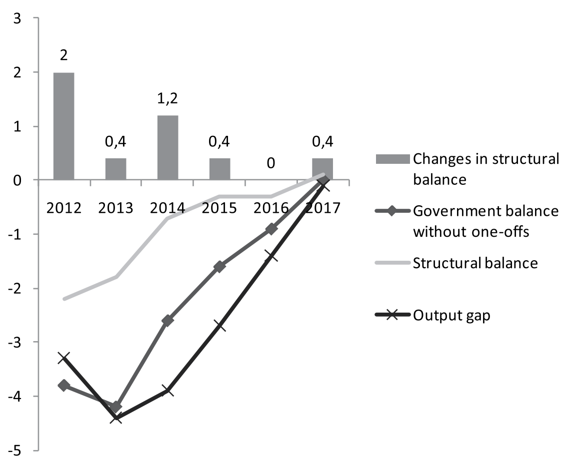
Fiscal policy in the SP13 is drawn against a worse macroeconomic background than in the SP12 and particulary with lower revenue without tax increasing measures. Slower economic recovery is foreseen in the period (2013-2016) which is reflected in terms of lower GDP and potential output growth rates and the postponement of the closing of the output gap at a lower potential output growth rate and level. Furthermore, the economic forecast is subject to high uncertainty and downside risks. They arise from the external environment and are conditional to the pace of implementation of policy measures in the banking system and of easing the deleveraging pressures on private non-financial corporate sector. In fact the IMAD 2013 summer forecast revised lowered the 2013 GDP growth rate estimate.

The SP13 envisages a gradual reduction of the deficit (headline and structural) in the period 2013-2017 underpinned by a substantial increase in tax revenue in 2014. This is because with the crisis and tax reform measures government revenue fell significantly. The pace of deficit reduction takes place against a scenario of gradual closing and elimination of the negative output gap by 2017 based on IMAD's 2013 spring forecast (Figure 9). This implies that the envisaged fiscal consolidation is consistent with a gradual economic recovery starting in 2014 and with a strong fiscal shock taking place in 2014 (improvement in structural balance by 1.2%) whose effect on economic activity, taking into account specific tax multipliers, could have a negative impact on GDP growth rate between 0.6% to 0.7% in 2014.

The SP13 policy mix is based on expenditure restraint and tax revenue increases (Figure 11). Expenditure growth is positive in the period 2013-2016 with the exception of 2015 (Figure 12) but the pace of growth is modest compared to the pre-crisis period (with an important shift in composition towards an increase in interest payments). On the other hand the revenue component of the adjustment is important in 2013 and particularly in 2014 where a number of tax increases should take place. Figure 13 highlights the importance of the increase in taxes. Notice also that similar tax revenue dynamics was implicit in the SP12 but the underlying measures were not explicit (i.e. increase in taxes or strong revenue collection (i.e. buoyancy)) or the effect offiscal consolidation in revenue dynamics was not fully factored in.

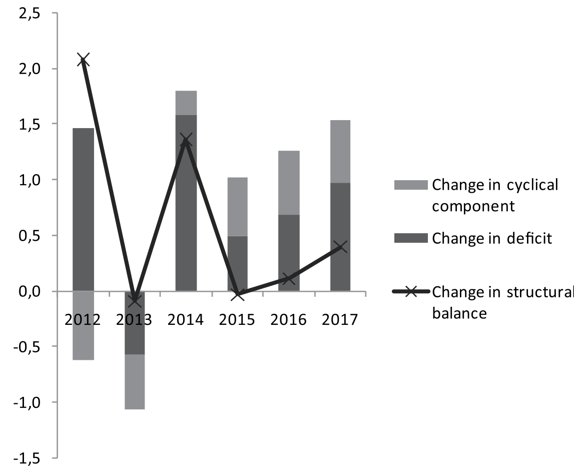
The SP13 suggests that the introduction of the so-called crisis tax is contingent to finding additional expenditure cutting measures and that the desired policy mix would be one relying on one third tax increases and two thirds expenditure measures. Figure 14 shows the expenditure dynamics that would have to take place in the case that all tax revenue measures envisaged in the SP13 would be replaced by expenditure cutting measures. In such a case, this would imply a shock in terms of expenditure growth in 2014 similar in size to that experienced in 2012. Provided that all expenditure reduction would take place in the item government consumption, this would imply that the economy would contract due to expenditure-consolidation by about 1.3% or by an additional 0.6% compared to the case in which consolidation takes place by tax increases as envisaged in the SP13. Under such a scenario the real GDP growth rate in 2014 would be negative (0.4%) and not positive (0.2%) as forecasted by IMAD in spring 2013 or more negative (0.8%) taking into account the latest IMADs forecast (Autumn 2013). Similarly, the rate of growth would be more negative in 2013 if the increase

Figure 9: **Fiscal targets in the Stability Program 2013, % GDP**



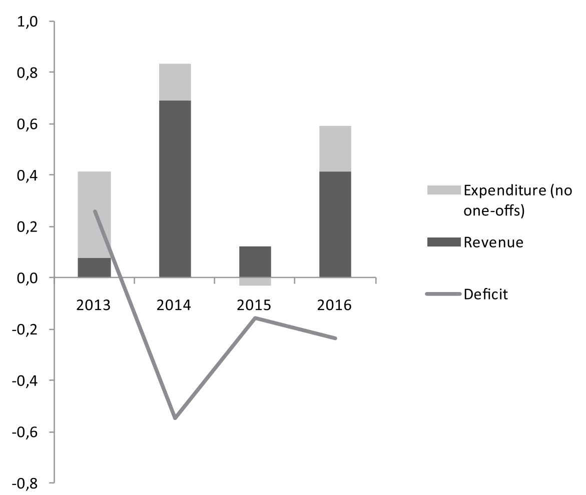
Source: SP13.

Figure 10: **Contribution to change in structural balance, %**



Source: SP13.

Figure 11: **Policy mix (Change € Bn)**

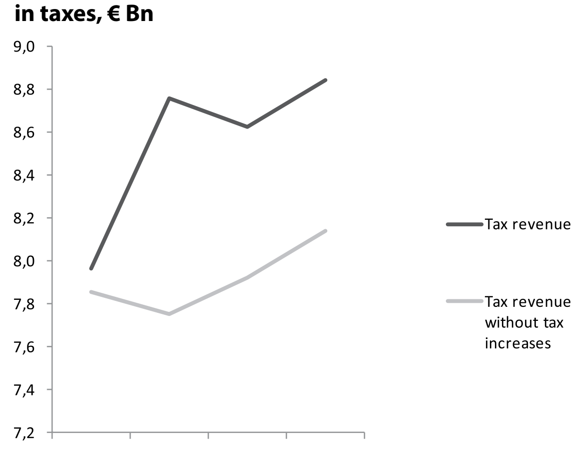


Source: SP13.

Figure 12: **Expenditure growth no-one off, YoY%**

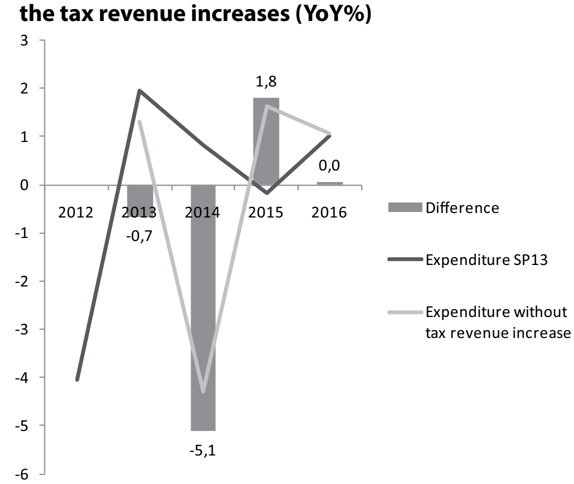
Source: SP13, own calculation.

Figure 13: **Tax revenue with and without planed rise in taxes, € Bn**



Source: SP13, own calculation.

Figure 14: **Expenditure growth, planned and replacing the tax revenue increases (YoY%)**



Source: SP13, own calculation.

in VAT rate would have been replaced by a reduction in government consumption.

The above illustrative assessment of policy impact on economic activity highlights the importance of the pace of consolidation and the policy mix in achieving fiscal goals. Notice also that with the envisaged tax increases in the SP13, the room for further tax increases seems quite limited. Yet, to some extent those increases compensate the tax reforms carried out in 2005-2007 and 2012 that reduced tax revenue without being compensated by expenditure reduction. This is also an important consideration to take into account when drafting the implementing legislation of Article 148. In particular tax reductions should be pre-financed by expenditure cuts or be revenue neutral. This is also consistent with the EU fiscal framework.

The fiscal projections to be used as a benchmark for assessing the implications of alternative fiscal rules or consolidation paths are subject to uncertainty arising from an economic environment which could result in lower economic growth and employment and thus lower revenue. Consolidation is also taking place in an environment that can turn deflationary (core inflation is already on a decreasing path) making it difficult to achieve consolidation goals and resulting in a prolonged recession. Besides this uncertainty, the budget projections do not include the envisaged interest costs of servicing the debt to be issued by the "bad bank" (DUTB), or by the government instead, which might not be negligible.

Thus, for the sake of credibility in the design and implementation of the fiscal rule it would be important to take into account the following considerations: the envisaged revenue dynamics underpinning consolidation (SP13); the effect of the fiscal shock in 2014 on economic activity; the potentially more severe impact on the economy from moving from revenue to expenditure shock in 2014; additional interest costs on debt issued by DUTB and a relatively optimistic interest payment schedule; and risks to revenue projections.

6. Defining the fiscal rule: making explicit in secondary legislation the concept of "balance between revenue and expenditure"

Although not only one but various fiscal rules can serve for the purpose of implementing the notion of the constitutional amendment of "balance between revenue and expenditure" in secondary legislation, Slovenia is bound by a legal contract (TSCG) to transpose into national legislation a balanced budget rule limiting the maximum structural deficit to 0.5% of GDP as well as to introduce an automatic correction mechanism for the event of significant deviations from it by 2014.[14] The transposition of the rule in national legislation is subject to monitoring by the EU Court of Justice and penalties would follow in case of noncompliance. This to a large extent narrows the available options to design the fiscal rule in the implemented law to one that at least includes the endorsed EU fiscal rule.

A narrow scope for defining the balanced budget rule does not mean that Slovenia cannot set alternative rules which can also comply with the TSCG balanced budget rule. However, the only freedom in this regard is only to set an even more demanding rule or in addition to the TSCG's rule, introduce other rules, which could make the overall fiscal process cumbersome. For example, more demanding balance budget rules would stipulate a "structural balance or surplus" or would limit the structural balance to a "minimum structural surplus of 0.5 % of GDP". In favour of the latter option it could be argued that the extreme volatility of the output gap estimates discussed above (i.e. need for a safety margin), the covering of a fraction of the present value of the projected increase in age related expenditure or ensuring that the debt is set on a declining path. Nevertheless, deciding on a more demanding rule should be made taking into account current economic conditions and provide an appropriate time frame for its implementation.

A more demanding rule is also not far beyond the actual demands of the EU legislation imbedded in the so-called "six pack". According to it, countries should, subject to penalties, not only reach and maintain their respective Medium Term Objective (MTO) defined in the structural balance terms, but in the process of approaching them they should ensure that deviations from a specified path of structural deficit reduction (0.5% of GDP as a benchmark) does not take place. Furthermore, according to the EU legislation, country specific MTO's should take into account three components: i) debt-stabilising balance; ii) supplementary debt-reduction effort for countries with debt in excess of 60% of GDP and; iii) frontloading adjustment to cover future increases in age related fiscal costs.

While in principle countries should set their own MTO's, it is the EC which assesses whether the country's own defined MTO's is appropriate. If the EC considers that a member's MTO is not appropriate, it can recommend to the EU Council to issue a recommendation to a given member state to change its MTO, which if not opposed

[14] Article 3 paragraphs (a) and (b) of the TSCG State" "(a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of structural deficit of 0.5% of the gross domestic product at market prices."

by the Council, means that the EC can impose a de facto fiscal rule to a given country. Such an event has a higher probability to take place in the case of a smaller country.Therefore, it is important to carefully draft the implementing rule and separate the concepts of fiscal rule and MTO.

The key issue concerning the calculation of the MTO for Slovenia and the de facto fiscal rule is the value of the front loading parameter to cover future age related expenditure which is subject to large uncertainty. Under an EC proposed 33% frontloading parameter of age related liabilities in 2010, Slovenia's MTO or overarching fiscal rule was estimated originally in a structural budget surplus at 0.7% of GDP. The large fiscal surplus defined in that MTO implied an ex-ante restrictive fiscal policy with respect to all phases of the business cycle. More recently, the EC revised estimate of Slovenia's MTO is a structural surplus of 0.25% of GDP.

The questionable issue regarding the frontloading parameter of contingent liabilities and its use in setting a fiscal rule is that it is arbitrary and can lead to sub-optimal outcomes and unwarranted fiscal effort particularly because of the uncertainty of age related expenditure (MF 2010). A gradual approach that takes into account the evolution of contingent liabilities in a period shorter than 50 years and includes them in the MTO calculation over a ten-year period on a rolling over basis seems to be a superior strategy in terms of economic activity and welfare and provides appropriate incentives for sustained pension reform (Caprirolo 2011). Such an approach also seems to be warranted because currently the structural deficit has to be corrected under demanding conditions of recession and weak external demand.

Another important issue is whether the balanced budget rule should have a maximum allowed structural deficit as a floor to the rule (i.e. Maximum structural deficit of 0.5% of GDP). While it can be argued that the text of the amendment to the constitution refers to headline deficit because it mentions that the balance should be achieved without borrowing, the fact is that without borrowing the public finances of the government can be unbalanced in structural terms leading to pro-cyclicality and deficit bias. In particular, this can be due to exposed measurement problems of output gap. For example, based on ex-post output gap estimates (2013)[15] it is possible to say that notwithstanding that the headline budget was balanced in 2007 (as it would demand the new fiscal rule if defined on headline budget accounts) the structural balance was in a deficit (3% of GDP). In fact revenue buoyancy in that period might have led to carry out a pro-cyclical tax reform undermining sustainability of public finances. Therefore, it would seem advisable to set a floor to the structural balance (which is also measured in national currency) which can be incurred without the need to recourse to borrowing or financing deficits with reserves generated in good times. A maximum structural deficit on the other hand can provide room for a countercyclical policy in bad times. Similarly important would be to implement conservative multi-year fiscal planning including a prudent planning parameter when estimating revenue or implement a rule with strong countercyclical features that would mitigate the problem of output gap estimates.

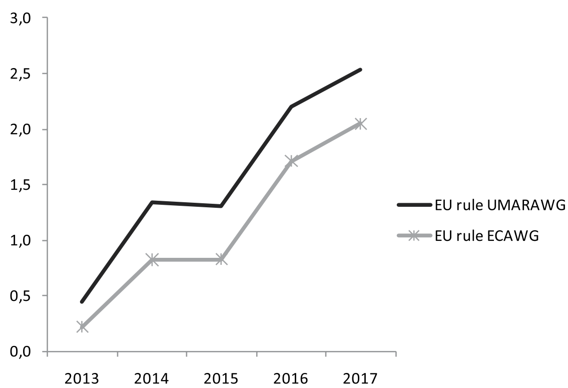
While the fiscal rule and the MTO could be identically set to ensure ownership of the rule and mitigate the problem of measurement of output gap in estimating the MTO, which is also subject to EC assessment, it would seem appropriate to separate the two concepts. The Public Finance Law should make them consistent and demand incumbent governments to spell out their MTO's with respect to the rule as more demanding or conforming to the rule. The role of the MTO could be one of setting the concrete fiscal targets that an incumbent government would pursue during its time in office but within the overall binding frame of the fiscal rule.

In addition to the TSCG's fiscal rule the inclusion of multiple rules can be considered. This could include rules constraining expenditure, revenue, debt rules, etc. The question to such an approach is the value added of multiple rules which can result in their overlapping and create a cumbersome policy setting. This is particularly the case because Slovenia is bound by other EU fiscal rules including a fiscal rule constraining nominal expenditure growth to the so-called reference "medium-term rate of potential GDP growth" (MTPG). The reference MTPG is calculated as the average of potential growth estimates of the previous 5 years, the estimate for the current year and the projections for the following 4 years. The forward looking component is estimated based on the Aging Working Group's (AWG) long-term GDP projections. Such an approach, anchored in future long-term GDP projections, has the purpose to mitigate the problem of volatile output gap estimates. Yet, even in this case the volatility of potential growth rate estimates in real time is not eliminated. For example the reference MTPG calculated with alternative GDP forecast made in April 2012 by UMAR and the EC and using the same long-term projections made by the AWG are different (Figure 15). The revised GDP forecast also changes the reference rate.

Defining the rule in terms of headline budget balance or in surplus seems to be the most transparent option anchoring overall fiscal stance. But, the issue is the potential pro-cyclicality of such a rule if reference is not made to a limit to the government balance defined in structural terms. The key challenge is relying on questionable output gap estimates in real time.

[15] Notice that with real time estimates (2007) of output gap such a statement does not hold as the structural deficit was estimated close to zero.

Figure 15: **Reference medium-term rate of potential GDP growth for government expenditure growth (YoY), alternative GDP forecast**



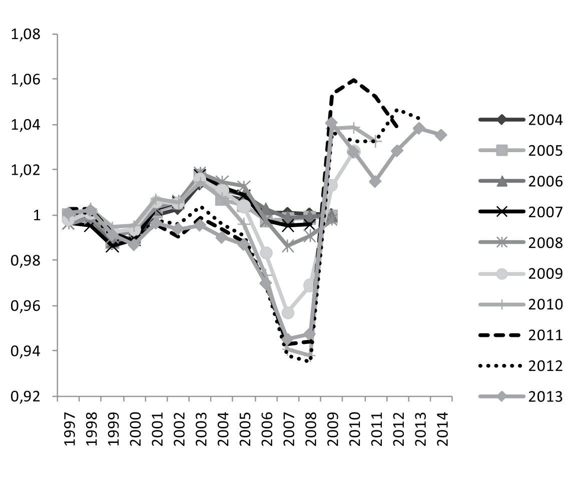
Source: EC, UMAR, own calculation.

If these estimates were certain, defining the rule in terms of structural balance would be appropriate. In particular pursuing a structural balance position to be met over time would provide room for an automatic countercyclical policy. Since this is not the case, the issue is how to design a balanced budget rule that is not pro-cyclical and that allows for a maximum degree of countercyclicality within the limits of automaticity or the EU fiscal framework. Such a task without explicitly mentioning the term structural deficit seems unavoidable, but its use in formulating the budget rule could be mitigated by playing a supporting role. Therefore, the wording of the rule could be one that entices a balanced position but at the same ensures enough room for automatic countercyclicality. Such a difficult task could be pursued by: a) defining the balanced budget rule according to TSCG in terms of the headline budget accounts with a limit on the structural deficit or; b) defining the implicit or explicit structural balance as the fiscal rule or choosing a more ambitious countercyclical rule where both options relying explicitly on output gap estimates. The latter is the case of fiscal rules that rely on output gap estimates in real time such as the Swiss debt brake rule (i.e. implicit structural balanced budget rule), the SP12 that is similar to the Swiss rule or alternative fiscal rules with stronger countercyclical features.

Defining the rule on the same terms than of the TSCG places emphasis on the headline balance budget position but ensures consistency with an allowed maximum structural deficit. To achieve this it is necessary to develop a consistent multi-year budget framework that ensures not only that a balanced budget is pursued in real time with the exception of exceptional circumstance but also limits the event of a structural deficit above 0.5% of GDP in line with maximum degree of automatic countercyclical strength.

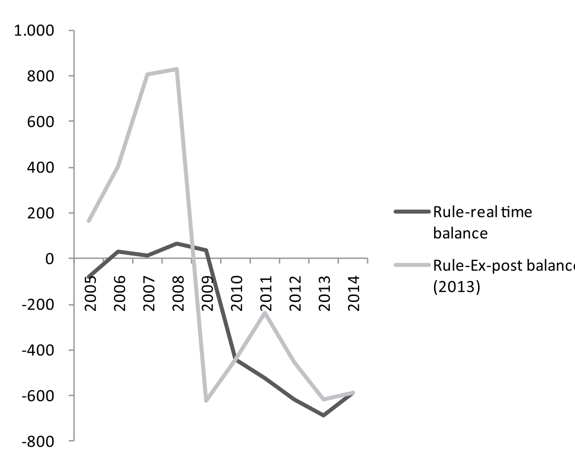
The alternative option is to define the rule implicitly or explicitly in terms of structural budget accounts placing emphasis in the conditions and calculations of output gap which is subject to large measurement error in real time. There can be various rules defined in structural budget accounts varying on their degree of countercyclical strength from stabilisation (i.e. limited to automatic stabilisers) to countercyclicality (i.e. beyond automatic stabilisers). A rule with limited countercyclical

Figure 16: **k factor calculated in real time (k=1/(1 + output gap)/100))**



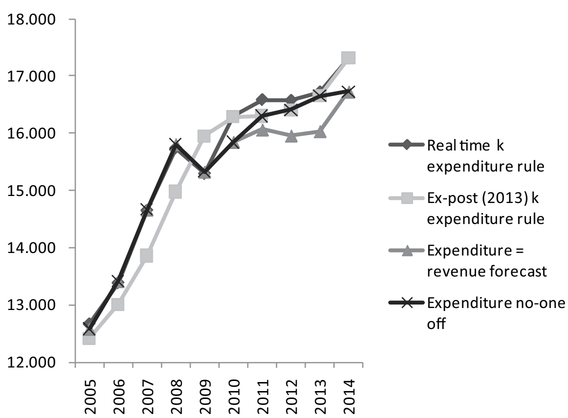
Source: EC, own calculation.

Figure 17: **Government balance under SP12 rule: using real time and expost output gap data , € millions**



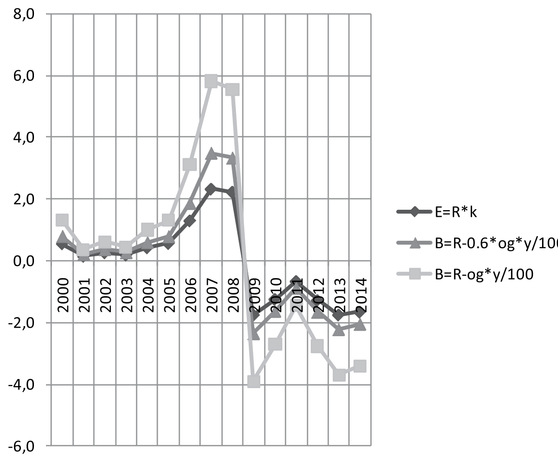
Source: EC, SP13, own calculation.

Figure 18: **Expenditure: Actual and under SP12 rule expost and ex-ante and simple balanced budget rule**



Source: EC, SP13. Own calculation.

Figure 19: **Government balance % GDP under alternative fiscal rules; Ex-post estimates**



Source. EC. Own calculation.

strength is the SP12 rule implementing the structural balanced budget feature of the Swiss debt brake rule.[16] While explicit attention on this type of rule can be placed on the limit to expenditure growth or debt, such a rule is in fact a structurally balanced budget rule. It requires that expenditure equals revenue adjusted by the output gap (i.e. so-called k factor) every single year. While in theory such a rule demands a structural balanced position at all times, it provides for limited automatic countercyclical strength depending on the size of the automatic stabilisers.

The key issue beyond the theory is that the SP12 rule relies on output gap estimates that are quite volatile in real time and which should be used in framing yearly budgets (Figure 16). Expenditure dynamics and consequently budget balances relying on real time estimates of output gap can diverge significantly from the same estimates relying on ex-post output gap calculations (Figures 16 and 17). Furthermore, the expenditure estimates based on that rule using real-time data from 2005 to 2010 deliver similar results to those following a simple headline balanced budget rule with a limited degree of stabilisation and with not enough degree of countercyclical strength during "good times" (Figure 18).

With similar issues concerning the identification of output gap in real time alternative rules with stronger countercyclical power than the SP12 rule can be considered. Figure 19 compares the SP12 rule with two alternative rules which differ in the weight given to an output gap correction factor called "c factor". The green line shows a rule with a 0.6 correction factor consistent with a maximum structural deficit of 0.5% of GDP in bad times and the red line shows a rule with a stronger automatic countercyclical power. Alternatively an asymmetric rule could be envisaged limiting the maximum structural deficit at 0.5% of GDP in "bad times" and a more stringent correcting factor for "good times" implying a stronger fiscal effort. However, this would add complexity to the fiscal framework. The rules including the correcting factor have stronger countercyclical power and could be defined as rules that ensure structural balance over time but not at all times. Given that in a rule-based world for a small open economy without a monetary policy there is a limited possibility for discretion; having a rule that has strong countercyclical features would seem preferable.

Taking into account the risks of measurement errors of output gap estimates in real time and the potential capacity to react quickly to changes in economic conditions it seems necessary to rely on a rule that is simple, transparent and underscores stability. Such a rule should provide predictability anchored in the medium-term budget framework with multi-year fixed expenditure ceilings and conservative revenue estimates that provides room for countercyclical behaviour within limits of automaticity. A headline balanced budget rule to be observed over time with a maximum structural deficit could serve such a purpose.

Taking into account the legal binding obligation derived from the TSCG, current economic recession and the envisaged slow economic recovery it seems that the option that minimises output loss, avoids making the fiscal framework cumbersome and mitigates pro-cyclical behaviour will be to define the concept "balance between revenue and expenditure" in similar terms as in TSCG i.e. "balance between revenue and expenditure" should be understood as a "observance of headline

[16] The rule also has another feature which consists of offsetting the accumulation of debt via correction of expenditure targets for past deviations from projected fiscal balances.

budget balance or in surplus over time with a maximum structural deficit of 0.5% of the gross domestic product at market prices".

Defining the overarching fiscal rule in those terms does not preclude that the fiscal policy in real time could be even more ambitious. It only sets the minimum threshold that would have to be respected. As mentioned, the Public Finance Law could demand incumbent governments to make explicit its fiscal stance against the rule when setting its MTO. Furthermore, when the economy recovers, specific targets in terms of frontloading contingent liabilities could be set or for reducing debt could be spelled out.

7. Defining the concept of "medium term" or when to achieve a balanced budget position

In addition of defining the rule implementing the concept of "balance between revenue and expenditure" there is another important issue to elucidate; the concept of "medium-term" when the rule should be met and become binding. In particular, the amendment to Article 148 states that revenue and expenditure have to be balanced in the medium term without borrowing. The wording "medium term" can be subject to different interpretations and this task becomes more complicated as the amendment says that the rule should be used in the 2015 budget preparation process.

The notion of medium term is ambiguous and can be interpreted in two ways with implications for real economic developments and for the role of a countercyclical fiscal policy. One interpretation of the concept "medium term" would be as a given point in time to be reached which cannot be postponed endlessly. The other could be as a process throughout time or over time, pointing to average behaviour over which the rule is met. If the notion of medium term is understood as a given point in time to be reached and it is combined with the concept of balance in government accounts (headline or structural basis) then the question is whether there would be a possibility for the budget to register a deficit (headline or structural) once the balance position is reached besides the case of exceptional circumstances which is also contingent on how the deficit is defined. Alternatively, if the medium term is understood as a process taking place over time then the possibility of occurrence of a deficit would be allowed independently of how the deficit is defined.

Understanding the medium term as a given date when the budget must be balanced raises the issue of neglecting the possibility of countercyclical possibilities within the limits of the rule if the concept of balance is defined in terms of headline government accounts or limiting countercyclical strength to stabilisation if the deficit is defined in structural terms. On the other hand, if the medium term is understood as a process taking place "over time", this would allow for a countercyclical policy in cases where accounts are defined either on headline or structural terms.

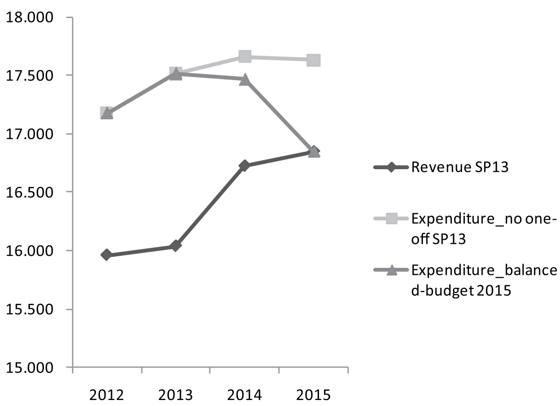
Since it is not clear how the medium term will be defined, there is a risk that under the ongoing economic recession the medium term is interpreted as a given point in time when the budget will have to be balanced either in headline or structural terms. This risk is particularly high if the medium term is defined before the time when the output gap closes or under strong uncertainty as to when the recession will end. This is because of the impact of pursuing fast balancing of government accounts on economic recovery.

Defining the medium term as a given point in time can be arbitrary. It could be set in the next 2-3 years, in 2015 or beyond. The notion can also be aligned with the length of the business cycle (i.e. end of contracting phase) which under current conditions and available data is difficult to pinpoint. In this regard the only guidance given by the parliament is that "revenue and expenditure should be balanced in the medium term" and that the rule should be applied in the preparation of the 2015 budget. Given the two-year budget preparation procedure, this implies that the rule should have been applied already in 2013. Therefore, the implications of implementing the balanced budget rule in a "medium term" defined as a given point in time and particularly before the time when the output gap closes should be assessed. A second issue concerns the case when the "medium term" is understood as a process over time and the rule has to be implemented in the preparation of the 2015 budget.

The first task is assessing the economic implications of balancing the government accounts in a time frame where there is a negative output gap. The year 2015 can be chosen as the medium term following a possible interpretation of the political agreement. The analysis concerns two options depending on how the government balance is defined: headline or structural government accounts.

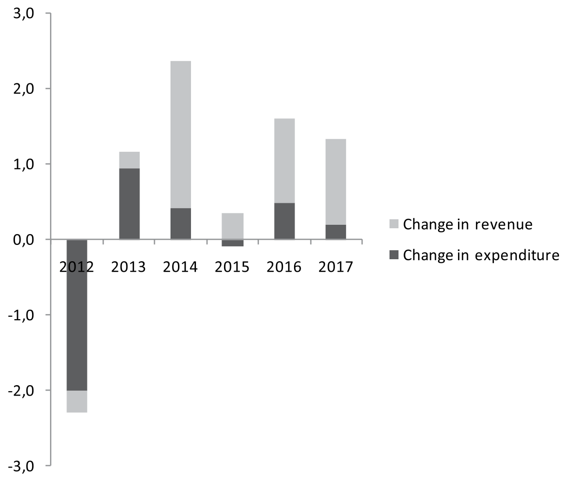
To draw implications of balancing the budget by 2015, such a policy is benchmarked against existing fiscal projections of the SP13 that foresees that the balance of the budget both in terms of headline and structural accounts should take place in 2017. To this purpose revenue projections of the SP13, including the envisaged tax increases, are used while it is assumed that the additional reduction in the deficit necessary to reach a balanced budgetary position by 2015 is achieved by means of permanent expenditure cuts. The starting point is the deficit position, without one-offs transactions, at the end of 2013 (4.2% of GDP (EUR 1.5 Bn.). For the sake of simplicity it is assumed that the

Figure 20: **Revenue and expenditure in the SP13 and when balancing the budget in 2015, EUR million**



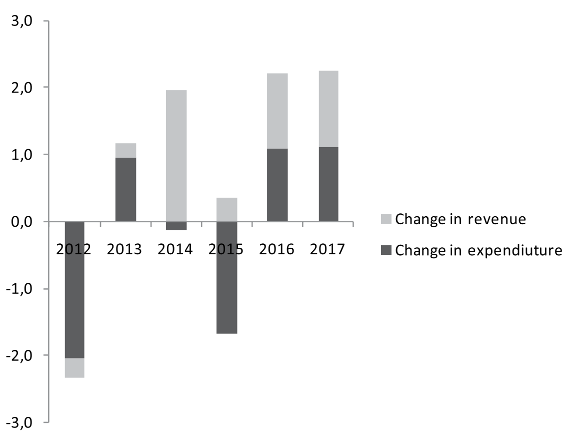
Source: SP13. Own calculation.

Figure 21: **Expenditure and revenue measures in the SP13, % of previous year's GDP**



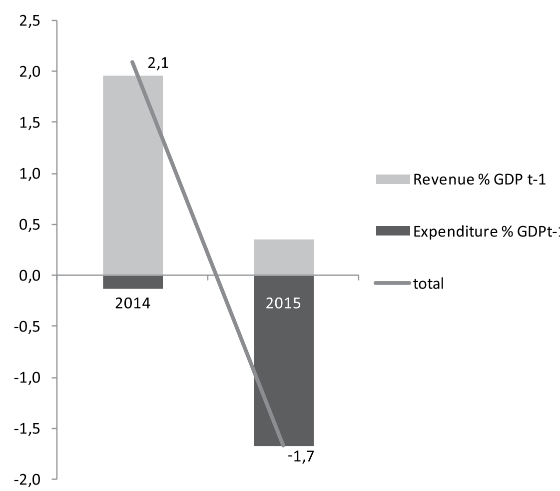
Source: SP13. Own calculation.

Figure 22: **Expenditure and revenue measures needed to balance the budget by 2015, % of previous year's GDP**



Source: SP13. Own calculation.

Figure 23: **Fiscal shocks required to balance the budget by 2015, % GDP**



Source: Own calculation.

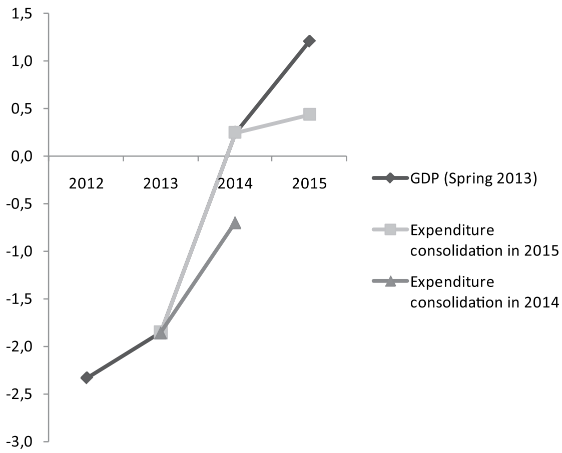
outstanding deficit at the end of 2013 is reduced by half in 2014 and 2015.

The first case corresponds to balancing the budget defined in headline accounts by 2015. Figure 20 shows the expenditure dynamics in the SP13 and those required to reduce the headline deficit to zero by 2015. It is assumed that additional expenditure cuts do not affect GDP dynamics beyond the effects included in the existing GDP forecast (April 2013) and revenue forecast. Thus, the size of ex-ante consolidation measures is equal to the outturn. For the year 2014, given the envisaged SP13 strong revenue increase only a slight additional expenditure would be needed (Figure 20). In 2015 the reduction of the deficit to zero would require a strong expenditure contraction of about 1.7% of the 2014 GDP which is currently not anticipated. Such a fiscal contraction would be similar in size to that experienced in 2012 with an important impact on economic activity.

Comparing the policy mix envisaged in the SP13 to that required to balancing the deficit by 2015 (Figures 21 and 22) suggests that for 2014 a similar sizable fiscal shock in the SP13 is foreseen while for 2015 a sizable additional expenditure reduction is needed. For 2016 and 2017 the SP13 foresees tighter expenditure restraints than the alternative policy of balancing the budget by 2015 which would allow expenditure to grow at the same pace as revenue.

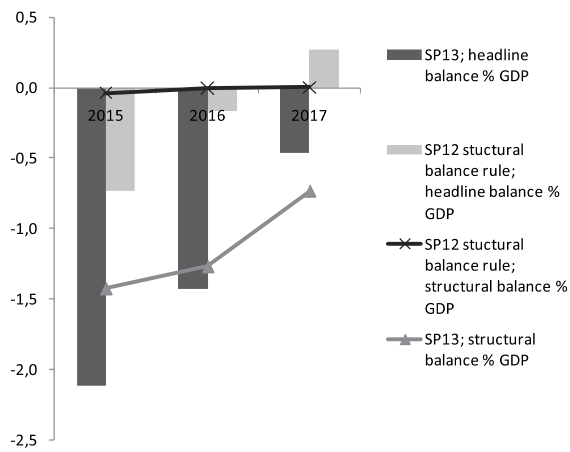
Without considering the effect of the two policy options on GDP (i.e. SP13 or balancing the budget in 2015), the two alternative policies would just reflect a trade-off between greater austerity in the short-run (2014-2015) for less austerity in the long-run (2016-2017). Nevertheless, to achieve a balanced budget position

Figure 24: **GDP real growth rate (% YoY) forecast and simulations**



Source: UMAR. Own calculation.

Figure 25: **Fiscal targets under SP13's fiscal projections and SP12's structural balance budget rule**



Source: SP12 and SP13, own calculation.

by 2015 two sizable consecutive shocks will be needed (2.1% GDP in 2014 and 1.7% of GDP in 2015), similar in size to that experienced in 2012 which could have important consequences on economic recovery and expectations (Figure 23).

Based on the baseline expenditure multipliers estimated by Caprirolo and Glažar (2013), the effect of the additional consolidation needed to achieve a balanced position on GDP by 2015 was estimated. Figure 24 shows the real growth rate of GDP estimated by UMAR in spring 2013 and simulations of the impact of additional expenditure consolidation measures on GDP growth rate. The simulations are made for illustrative purpose as the size of multipliers can be different and the response to successive shocks could be non-linear. The starting point is the assumption that the 2014 GDP forecast already reflects the full impact of the planned tax increases. Building on that shock, the effect of an ex-ante reduction of expenditure (i.e. government consumption) in 2015 by 1.7% of 2014 GDP was calculated. Such a shock would reduce the forecasted GDP growth rate in 2015 (UMAR spring 2013) by 0.8% from 1.2% to 0.4% or close to 0% taking into account the summer 2013 forecast. Notice that in the simulations of fiscal shocks on GDP government revenue is not decreased nor the fiscal target affected which in fact should be the case as the size of ex-ante consolidation is likely to deliver a lower ex-post size of fiscal consolidation.

Figure 24 also shows the impact of replacing the SP13 policy mix for 2014 (i.e. relying mainly on tax increases) by expenditure measures. They include additional expenditure cuts needed to reduce the deficit by half totalling altogether € 740 million. Given larger expenditure than revenue multipliers, the effect of switching from revenue to expenditure consolidation measures would deliver a more negative growth rate in 2014 compared to SP13. As a consequence of that shock the closing of the output gap will be further postponed.

The key issue, which is difficult to foresee, is the impact of an extended period of low GDP growth rates on expectations, economic activity and fiscal targets themselves.

The second case is to assess the implications of defining the medium term as 2015 when the balanced budget rule becomes binding and is defined in terms of structural balance. This would correspond to assess the implementation of the SP12 endorsing the Swiss's debt brake rule or a structural balanced budget rule. To this effect SP13 revenue projections are used.

Implementing the SP12 structural balanced budget rule by 2015 would require additional expenditure tightening (Figure 25). For 2015 additional expenditure cuts of about 1.4% of GDP would be needed. Based on estimated baseline multipliers (Caprirolo and Glažar 2013) the effect of such a fiscal shock would be to reduce the 2015 GDP growth rate by about 0.6%. On that account the 2015 GDP growth rate forecasted in summer 2013 by UMAR could be lower and is estimated in 0.4%.

Implementing a balanced budget rule defined either in terms of headline or structural terms by 2015 or when the economic recovery is not firmly anchored is likely to result in a sizable fiscal shock. The short-term consequences of that policy can be more adverse taking into account that a sizable fiscal shock is already envisaged to take place in 2014. Therefore, given current adverse economic conditions, if the medium term when a balanced budget rule (headline or structural basis) becomes binding is interpreted as of a given point in time, such a date should be 2017 at the earliest or beyond when there is certainty that the output gap is closed.[17] Following such an approach can mitigate the fiscal cost of fiscal consolidation. Additional arguments

[17] Notice for example that Spain introduced a balanced budget rule in structural terms in the Constitution which will be enforced by 2020.

favouring such an approach would include: i) the effect of fiscal consolidation on economic recovery, tax revenue and fiscal targets themselves; ii) the fact that the interest on the debt to be issued to clean the banks' balance sheets is not going to be negligible and has to be consolidated within the general government and thus require additional fiscal effort[18]; iii) interest payments in the SP13 projections might be optimistic and; iv) the benefits of the low interest rates in the EMU are not fully transmitted to the Slovenian economy as the interest rate channel is hampered and the credit channel clogged demanding a relatively more anti-cyclical stance. Making a rule binding where conditions are not likely to result in its success can undermine the credibility of the rule itself.

Enforcing a balanced budget rule defined in terms of headline or structural accounts once the output gap is closed seems more advantageous for the economy and credible. Nevertheless, the question would be whether other rules can better serve the purpose of the fiscal policy particularly with regards to countercyclical strength. Answering this question leads to assessing the implications of defining the medium term as a process over which the rule should be met.

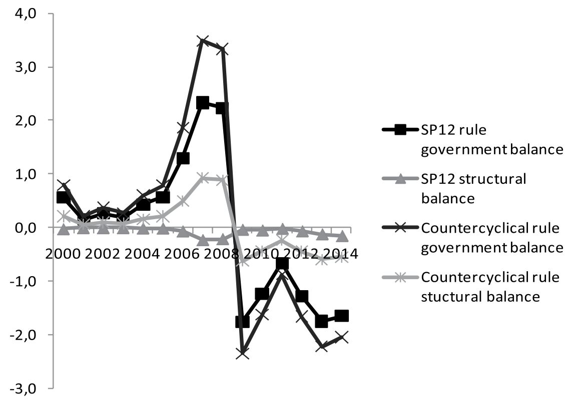
Unlike a balanced budget rule defined on a headline or structural basis (e.g. Swiss debt brake) that requires that at all times the balanced budget is maintained, a rule can be designed requiring that the balance position is met on average over time. This would enhance the countercyclical power of a rule-based fiscal policy. This could have advantages for Slovenia given that it is a small economy without an independent monetary policy.

A balanced budget rule that should be met over time can also be defined in a headline or structural basis. The TSCG's fiscal rule can be conceived as a headline budget balance rule that should be met over time. The rule is defined in headline terms but allows for a maximum structural deficit of 0.5% implying the possibility of a certain degree of countercyclical policy. Alternative rules to that of the TSCG that are met on average over time and with stronger countercyclical properties than that of the SP12 (Swiss debt brake rule) are the type of rules specified above which are defined on structural accounts and rely on a correcting factor to the output gap. The workings of these alternative rules are depicted in Figure 26 and compared with the SP12 rule. It is clear that a rule with stronger countercyclical features is more desirable taking into account the two phases of the business cycle.

Defining the balanced budget rule to be met over a medium term also requires setting a date when the

[18] Assuming that the interest rate on the debt to be issued is 5% per year and the debt to be issued is € 2 Bn. Out of the potential € 4 Bn. this would increase the deficit by about 0.3% of GDP.

Figure 26: **Government balance under alternative fiscal rules: structural balance and countercyclical,% GDP**



Source: SP12, own calculation.

rule begins to be enforced. Taking into account the envisaged projection of the SP13, the introduction of a balanced budget rule (defined in headline or structural terms) with a maximum structural deficit of 0.5% of GDP should be also set beyond 2017. Given the importance of the countercyclical dimension in whatever balanced budget fiscal rule, it would be convenient to interpret the medium term as a process over which the fiscal balance is met. In such a context it would also be preferable to define the rule in terms of structural balance over time; meaning that the structural balance is not met at all times but on average. Nevertheless, output gap estimates in real time are uncertain and it is relatively difficult to adjust government balances over a relatively short period of time. Therefore, to preserve the advantage of countercyclical strength of the rule and transparency of its definition, the balanced budget position should be defined in headline basis but should be met over time with a maximum structural deficit.

Taking into account the arguments put forward, the amendment to the Constitution demanding that "Revenue and expenditure should be balanced over the medium term" could be transposed into secondary legislation in the following terms: "The government headline budget should be in balance or in surplus over time with a maximum structural deficit of 0.5% of the gross domestic product at market prices". The limit on the maximum structural deficit shall not be exceeded with the exception of national catastrophes, economic recession including the level of the euro area as defined in the Stability and Growth Pact or extraordinary emergency. In all cases these circumstances would be unusual events outside the control of the incumbent government with a major impact on the financial position of the general government. Deviations from the balanced budget rule or from the adjustment to the rule under no exceptional circumstances shall be corrected the following year at the latest. In case of deviation from the rule and adjustment towards it due to exceptional circumstances, including protracted recessions resulting in an accumulated loss of output during more than one year period of low annual GDP volume growth relative to its potential, it should be corrected according to a minimum fiscal effort of at least of 0.5% of GDP structural deficit reduction once out of the escape clause period.[19]

Defining 2017 or a later year as the date when the rule should become binding does not mean that in between there will not be fiscal consolidation. In fact it should take place at least in accordance with the pace defined in the SP13. Furthermore, Slovenia is obliged under EDP recommendations and EU legal framework, subject to sanctions, to pursue consolidation and a balanced budget position which, under current output gap estimates, should not take beyond 2017 (5 years). Therefore a relevant issue is also how to make compatible the timing in which the rule becomes binding and EU obligations also taking into account the implication for the economy.

8. Applying the rule in the 2015 budget preparation process, exceptional circumstances and setting the convergence path to a balanced budget position with a maximum deficit of 0.5% of GDP

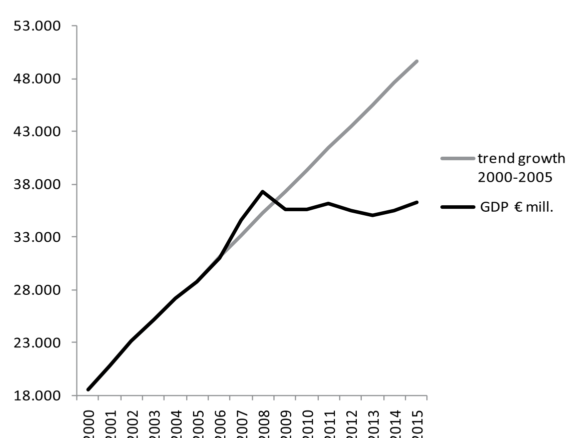
If the overarching rule to be applied is a balanced budget rule as proposed above or in other terms, the question to address is the implication of the parliamentary agreement regarding the guideline that the rule shall be applied in the 2015 budget preparation process.

Answering such a question requires placing fiscal policy in the context of broad economic conditions currently facing Slovenia. This is because any fiscal rule also has attached conditions under which it is not applied. A fiscal rule holds under normal economic conditions and cyclical movements but it is not binding under exceptional circumstances. Thus in a rule based framework the rule and the condition of exceptional circumstances are inseparable concepts. Not abiding to exceptional circumstances in formulating a fiscal policy when conditions are such would imply violating the rule in itself (i.e. the rule and its exceptions have equal legal weight).

Recent economic forecasts including data on GDP and output gap clearly indicate that the economy is undergoing a protracted recession. Economic growth was negative in 2012 and it is envisaged to be negative in 2013 and likely to be so in 2014 (3-year consecutive recession). Not only that, but since 2009 the economy is experiencing a prolonged period in which output is being lost as measured by the difference between the GDP 2000-2005 trend level (trend before the boom) and actual GDP level (Figure 27).The accumulated loss of output in the period 2009-2015 is estimated at € 54 billion or 1.5 times the forecasted GDP level in 2015.

The magnitude of the economic slowdown is reflected in the two consecutive years (2012-2013) as a positive difference between the growth rates of potential output and GDP as estimated by the EC in spring 2013 and the persistent positive gap between potential growth and GDP. The likelihood of this to continue in 2014 is high given the weak economic recovery and potential impact of fiscal shocks either via tax increases or higher if consolidation is done through expenditure cuts. An additional important consideration is the potential growth rate, currently estimated as negative, which is in fact difficult to pinpoint with the same methodology that overestimated it during the boom. Thus the positive difference between potential and actual output growth rates could be even larger suggesting that the economy is undergoing several years of lower GDP growth than its potential.

Figure 27: **GDP trend level and forecast, € millions**



Source: SORS, UMAR. Own calculation.

In light that the economy is already experiencing large accumulated loss of output for more than one year and annual GDP volume growth has been lower relative to its potential for at least two consecutive years, it can be concluded that the economy is undergoing a period that would qualify as of exceptional circumstances under any sensible fiscal rule. This would be the case under the enhanced EU legal framework. Thus, if the starting conditions upon which the new fiscal rule should apply correspond to exceptional circumstances, then the natural way of applying the fiscal rule's framework would be to determine until when these exceptional conditions will last and then devise a corrective path towards meeting the rule. This could be done according to a pre-determined corrective mechanism, discretionary policy, EU rules or additional rules devised for such a purpose.

[19] According to the EU, enhanced fiscal framework correction should consist of a reduction in structural deficit by 0.5% of GDP. This number could be subject to discussion particularly when the economy is coming out from a deep and protracted recession.

Taking into account the ongoing conditions of a severe recession, in which actual GDP growth rate is below that of potential and where there is a significant fall in output level, the period of exceptional circumstances is likely to last at least until 2015. While according to the most recent forecasts the GDP growth rate would be higher than that of potential output in 2014, there is a large margin of error measuring potential output and uncertainty as to the negative impact of fiscal consolidation on growth, bank's balance sheet cleaning and external demand on it. Thus, if the period of exceptional circumstances lasts until 2015 and from then onwards convergence to the rule has to be insured, the issue is the optimal policy during the period 2014-2017. The available policy options in this regard could be the following: a) implementing the discretionary fiscal policy envisaged in the SP13; b) pursuing the fiscal targets recommended by the EC to Slovenia in the review of the SP13 as part of the process of correcting the excessive deficit procedure; c) trailing the minimum fiscal effort of reducing the structural deficit by 0.5% of GDP once the deficit is below 3% of GDP as demanded by the enhanced EU fiscal framework; d) devising ad-hoc national rules or procedures for this purpose and; e) reducing the deficit by relying on a multi-year budget framework with binding expenditure ceilings.

The first option of following the SP13 fiscal policy, without being explicitly underpinned by a rule, foresees that the fiscal accounts will register a slight surplus in structural terms by 2017 consistent with a slight headline deficit of 0.5% of GDP. The pace of achieving this budgetary position measured in terms of changes in headline and structural balances is uneven. With the largest effort in terms of structural and headline deficits reduction taking place in 2014. In 2013 the improvement is mainly due to worsening of the output gap while in 2016 there is no improvement in structural terms despite of the deficit reduction. The overall consolidation effort relies strongly on an increase in tax revenue in 2014 with the impact beyond that year. Looking at the size of headline and structural deficits at the end of 2013 it would seem that reducing the structural deficit by about 1.6% is straight forward. Yet, because of the dynamic of the output gap this requires at least a sustained and permanent reduction of the headline deficit by about 1% of GDP per year during 2014-2017. The key issue in pursuing such a strategy is that it needs to be underscored by explicit and binding expenditure ceilings which at the current point in time are missing. Another important challenge is to ensure an equally sizable reduction of the deficit.

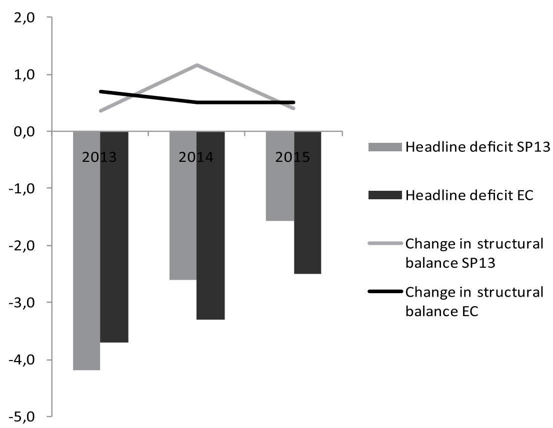
The second alternative to converge to a balanced position would be to follow the EC recommendations. The EC acknowledge that the double dip recession in Slovenia would last until 2014 and thus extended the deadline for the correction of the excessive deficit by two years. As a consequence the EU Council recommended that Slovenia reduce the headline deficit in 2013 to 3.7% (lower by 0.5% than the SP13) and the structural deficit by 0.7% (stronger fiscal effort than in the SP13). It also gave recommendations for the years 2014 and 2015 with the aim to reduce the headline deficit below 3% of GDP consistent with a pace of structural deficit reduction of 0.5% annually (Figure 28). Based on those recommendations the headline deficit should be 2.5% of GDP by 2015 and the structural deficit would have to be reduced as estimated by the EC from 2.7% of GDP in 2012 to 1% of GDP in 2015. The issue with such a strategy is the relative ex-ante strong structural deficit reduction demanded for 2013 amidst negative growth and, in general, the size of the structural deficit reduction in the period 2014-2015 when there is strong uncertainty as to the impact of fiscal contraction on GDP. Another important dimension is also the timing in which policy measures can be designed and implemented which may not necessarily coincide with recommendations unless they are planned ex-ante to be more demanding than the recommendations themselves.

If the EU fiscal framework and targets are binding constraints, then the issue is whether additional rules or effort beyond that demanded by the EU implicit rule should be pursued in Slovenia during the period of excessive deficit correction and beyond (i.e. convergence to the balanced budget rule from a position of deviation under exceptional circumstances) or simply that the minimum improvement in structural balance should be targeted and follow with the discretionary policy and robust medium term budget framework.

Creating additional rules for the process of convergence to a balanced budget position risks making the policy process more cumbersome and could also result in demanding more fiscal effort than warranted under the EU rules with important implications for the economic recovery. Based on these considerations it can be argued that the process of convergence from a position of exceptional circumstances to a balanced budget could be pursued by: a) adhering to EDP policy recommendations until 2015 or claiming exceptional circumstances if conditions warrant; and b) reducing the structural balance by the minimum prescribed speed during 2016 and 2017. Comparing such a policy with that of the SP13 (using EC output gap estimates) indicates that the target fiscal consolidation requires a headline deficit reduction of about 1% of GDP every year (Figure 29). Nevertheless, such a pace of permanent deficit reduction per-se seems quite demanding under current conditions.

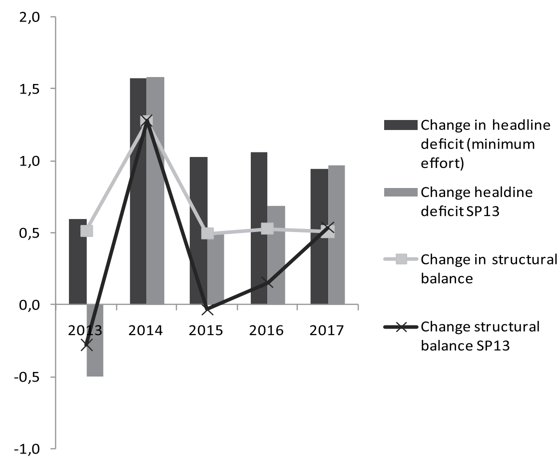
Notwithstanding the implications for the economy, a more demanding rule for the process of convergence to a balance budget position could be endorsed. This could be the case if the SP12 rule is applied from 2015 onwards. Its application at whatever point in time demands a structural balanced budget position which under current exceptional circumstances seems unwarranted. Implementing the SP12 rule would deliver a larger shock than that followed under EU implicit set of rules. For example, if implemented in 2014 it would

Figure 28: **Fiscal projections, SP13 and EC 2013**



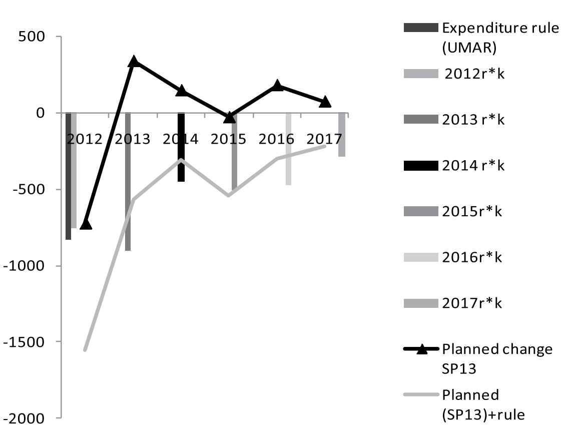
Source: EC and SP13.

Figure 29: **Change in fiscal targets, % GDP**



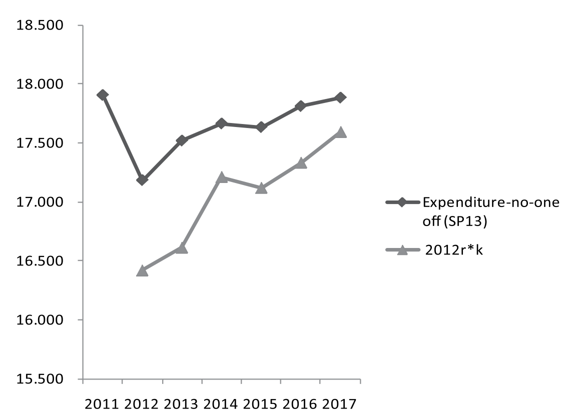
Source: SP13. Own calculation.

Figure 30: **Expenditure change (YoY) under alternative (year) in which the rule would be implemented, € millions**



Source: SP13. Own calculation.

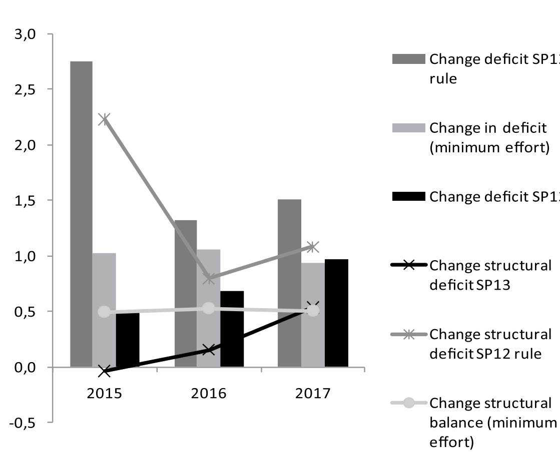
Figure 31: **Expenditure dynamics: Planned (SP13 annd under SP12 rule (€ millions)**



Source: SP12 & SP13. Own calculation.

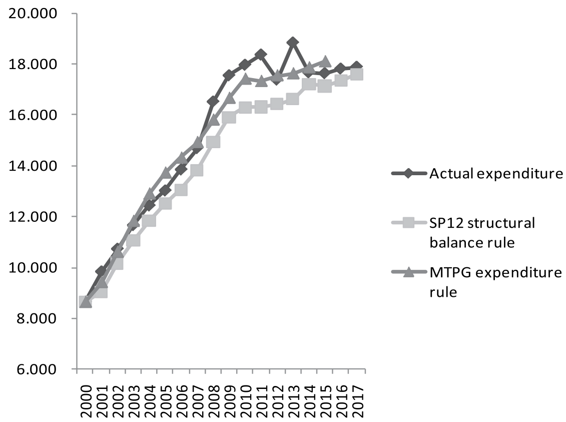
demand in addition to the envisaged tax increases expenditure cuts in the amount of 1.4% of GDP (Figure 30). More generally, the introduction of such a rule when the difference between expenditure and revenue is sizable would result in a large shock at the time of its implementation which is likely to be the case until 2017. In addition, the sustainability of the measures is also important since they reduce expenditure sharply (Figure 31) and set expenditure growth on a declining trend which is more binding than that envisaged in SP13 and EU fiscal rules, particularly at the time of its implementation. Therefore, the issue is to determine which expenditure trajectory among those foreseeable (i.e. government policy SP13, SP12 rule and EC recommendations) is more consistent with a gradual recovery and feasible and to which degree the EU rules are the more binding constraint (Figure 32). Clearly the policies of the SP13 or EC targets seem to be the better options. It can be also argued that during 2014-2015 a

Figure 32: **Alternative policy consolidation, % GDP**



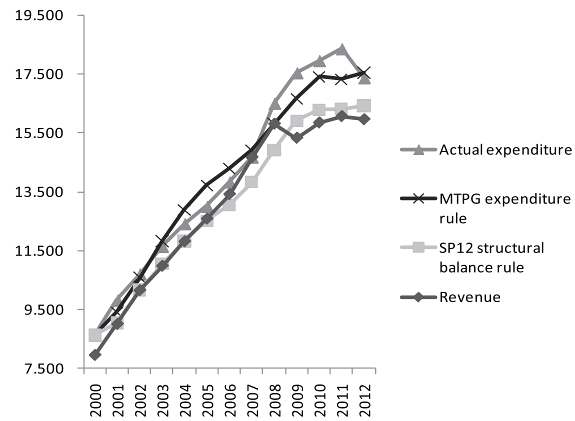
Source: SP12 & SP13. Own calculation.

Figure 33: **Government expenditure: actual and under alternative rules (€ millions)**



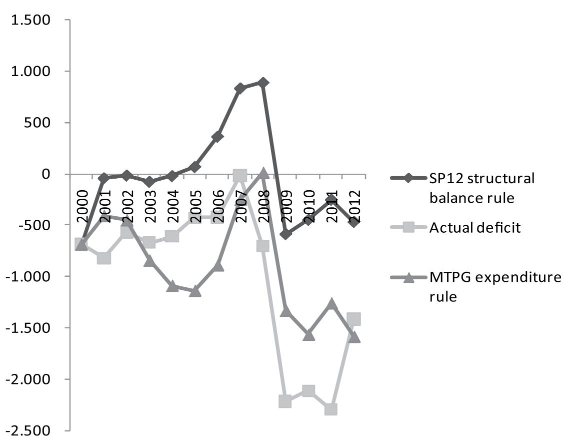
Source: SP12, own calculation.

Figure 34: **Revenue and expenditure under alternative fiscal rules, € millions**



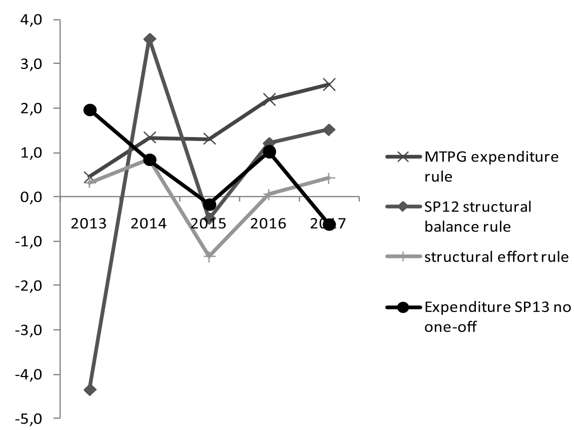
Source: Own calculation.

Figure 35: **Deficit under alternative rules, € millions**



Source: SP12, SORS and own calculation.

Figure 36: **Comparison of alternative rules on expenditure behavior, YoY%**



Source: SP12, SORS and own calculation.

discretionary policy would be critical in anchoring and pursuing consolidation and deliver an outcome close to that demanded by the EU framework.

Designing additional rules for the period of convergence to a balanced budget position can also result in unnecessarily constraining the fiscal policy afterwards. This for example can be inferred by comparing the SP12 rule with the EU's MTPG expenditure rule as discussed above. While the SP12 is essentially a balanced budget rule, it can limit expenditure growth beyond that demanded by the EU expenditure rule. This concern is relevant regarding the scope for countercyclical policies in bad times and while the private sector's provision of public services is relatively limited. Figures 33-36 show the implications of the EU expenditure rule and SP12 rule compared to actual developments and forecasts.

Given the EU binding rules and sanctions it seems that the process of eliminating the structural deficit once the headline deficit is below 3% of GDP, should trail the 0.5% per year structural deficit reduction. This would argue for making the minimum effort a binding rule when the deficit is corrected from exceptional circumstances but not for including more demanding rules. Alternatively, to avoid complicating the fiscal framework the implementing law could only demand the parliament to determine when exceptional circumstances cease. When this is the case and depending of the severity of recession, the parliament should set in motion a correction procedure in which it decides the time frame and speed in which the deficit is eliminated. The government in pursuing deficit correction should at all times adhere to a medium term budget framework (MTBF). It should have binding nominal multi-year expenditure ceilings calculated taking into account uncertainty of revenue projections to achieve the targets derived from the EU fiscal rules and to avoid sanctions. Thus, the approval of the law implementing the fiscal rule and changes to the Public finance law should take place at the same time.

A final question concerning fiscal rules is whether to reinforce the fiscal framework and whether an expenditure rule should be introduced in addition to the suggested balanced budget rule. If the MTBF is enhanced this would not be needed. What might be even more necessarily, given the observed bias to carry out tax revenue reducing reforms is to forbid such a practice by requiring their prefunding with expenditure cuts. If an expenditure rule would be deemed necessary in any case, then the EU's MTPG expenditure rule should be endorsed given that it provides the maximum room for manoeuvre to an economy that already has limited policy instruments.

Deviations from the balanced budget rule could also take place due to policy planning. In particular, ex-post significant deviations from the balanced budget rule or adjustment towards it can happen due to estimation of potential output or due to optimistic planning. Such deviations should trigger an automatic correction the following year. Accordingly, the correction should take place at a minimum speed of structural deficit reduction of 0.5% of GDP. Such a provision would also be consistent with EU fiscal legislation.

The monitoring of compliance with the fiscal rule (ex-ante and ex-post), the correcting mechanism after exceptional circumstance cease and automatic correcting mechanism in case of deviations not associated with exceptional circumstances should be entrusted to a newly created Parliamentary Budget Office (PBO) under the National Parliament or to an existing institution whose institutional mandate should be enhanced (Caprirolo, 2011).

9. Conclusions

The fiscal rule operationalising the amendment to Article 148 of the Constitution should read as follows "The headline budget accounts should be balanced or in surplus over time with a maximum structural deficit of 0.5% of the gross domestic product at market prices". This rule shall be applied to consolidated general government accounts defined on an ESA 95 basis. Defining the fiscal rule based on headline budget terms provides transparency and enhances accountability. Alternatively, defining a rule with relation to output gap as its core carries the problem of uncertain output gap estimates in real time. The rule should be met over time using the full room for countercyclical space within the boundaries of not creating debt and limits of EU fiscal framework. The rationale for making reference and setting a maximum structural deficit (0.5% of GDP) in the rule (unavoidable) is to avoid pro-cyclicality while providing countercyclical power to the rule within the constraints imposed by the EU fiscal framework. It also provides a margin to cope with uncertainty related to measurement of the output gap. Setting the rule in those terms does not preclude the Law on public finance to demand from incumbent governments at the beginning of their mandates to set a medium term objective which is more demanding than the rule. The rule would have the role to set the minimum standards of fiscal responsibility to be observed at any time.

An inseparable component of a fiscal rule is the definition of their escape clauses under exceptional circumstances. To ensure consistency with the SGP, the same definition of exceptional circumstances should also be employed in the implementing law of Article 148. Exceptional circumstances are also a temporary phenomenon upon which correction and convergence to the rule should be demanded. The concrete criteria assessing the end of the exceptional circumstances period could be drafted in detail in the implementing law as well as the mechanics defining the convergence to the rule (time and speed of structural deficit reduction).

In cases where deviations from the adjustment path to the rule, or deviations from the rule itself would be due to estimation problems related to output gap or fiscal slippages, then an automatic correction process should be demanded. Sizable discrepancies (exceeding 0.5% of GDP) should be corrected the following year in which they take place. Monitoring compliance with the rule (ex-ante and ex-post) and application of the automatic correcting mechanism should be monitored by a newly established Congressional Budget Office or by an existing institution whose mandate could be enhanced.

The economy is undergoing a period of exceptional circumstances and as such abiding to the new fiscal rule also implies abiding to its escape clauses. The following conditions argue for such interpretation: i) the GDP growth rate is below potential for at least two years; ii) there is uncertainty as to whether potential growth is higher than estimated with existing measurement techniques implying uncertainty as to when the output gap will close; and iii) the loss in output being massive (€ 54 billion accumulated between 2009-2015). In addition there are downward risks to the outlook given potential sizable fiscal shocks and economic and fiscal implications of the banking system's balance sheet cleaning. Therefore, under current conditions compliance with the rule in the preparation of the 2015 budget would imply recognising that until 2015 the economy is going to remain under exceptional circumstances and from then onwards a period of convergence to the rule shall take place at the minimum adjustment rate prescribed by the parliament or in accordance to SGP of 0.5% structural deficit reduction annually. This means that the fiscal rule shall be met by 2017 at the earliest. Notice that these estimates are broadly in line with the SP13 fiscal projections, which in any case are underpinned by a substantial revenue shock in 2014 and are subject to great uncertainty derived from economic activity and the cost associated with the cleaning of banks' balance sheets. Such a time frame is also consistent with obligations derived from EU procedures and legislation. Bringing forward consolidation by means of forcing the introduction of a balanced budget rule defined in headline or structural accounts before the time when the output gap closes would unduly restrain recovery beyond the demands derived from the EU framework.

Given obligations derived from EU legislation and the outlook of weak economic recovery it seems unnecessary to introduce additional fiscal rules besides those that were endorsed by Slovenia in the EU framework as they can result in an unwarranted tightening of economic activity. The expenditure rule endorsed by Slovenia in the "six Pack" seems to provide enough room for manoeuvre in terms of countercyclical properties and it is also consistent with an implicit structural balanced budget rule that is met over time. Such room for manoeuvre seems appropriate when the degree of policy discretion is strongly curtailed and where policy actions at the euro area level seem to affect members asymmetrically.

The compliance with the rule and convergence towards it cannot be made possible without a robust medium-term budget framework with multi-year binding expenditure ceilings taking into account a margin of uncertainty of revenue projections and assessment of cyclical conditions. Setting such a framework and monitoring compliance is of outmost importance to underpin the rule based fiscal framework. Equally important is to pass legislation forbidding tax reform that is not fiscally neutral (i.e. proceeded by expenditure cuts or other revenue increases). To ensure consistency it is recommended that the approval of the implementing law of the fiscal rule and changes to the Public finance law take place at the same time.

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