

# economic issues 2010

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# **Part I**

## **Fiscal development and policy**



## Summary

***The slowdown in economic activity resulting from the global financial and economic crisis, and fiscal measures taken to combat the crisis, led to substantial deterioration of public finances in euro-area and EU countries in 2009;*** most EU Member States have been in excessive-deficit procedures since last year. Average general government debt in the euro area and the EU rose rapidly due to high general government deficits and large-scale financing of measures to prop up the financial sector through government borrowing. Portugal, Spain, Italy, Ireland and, in particular, Greece stand out as countries whose public finances are in a much worse state than the euro area average. In early 2010, Greece requested financial aid in the amount of EUR 110 bn amidst growing tension on the financial markets. To counter the risk of the crisis spreading from Greece to other euro-area countries, and given the fall in the value of the euro, measures were taken at EU level, including aid to Greece along with expansion of the existing European balance-of-payments facility from countries outside the euro area to euro-area members, and agreement on establishing a permanent mechanism in the EU to ensure the stability of the euro. The ECB contributed to tackling the crisis by deferring implementation of its exit strategy of gradual phase-out of liquidity measures, and by committing to directly purchase sovereign and private debt securities. Under the circumstances, these solutions were urgently required to avert destabilisation of the euro area, but they are not a long-term solution; this will require systemic adjustments and changes in the institutional framework of the EMU.

***The severe worsening of the imbalance of public finances in Slovenia in 2009 was also largely a result of the fallout from the financial and economic crisis.*** At the end of 2008, and in particular in 2009, as the economic situation substantially deteriorated, the cyclical component of the deficit surged. General government revenue dropped as a result of the deterioration of macroeconomic trends and the effects of tax changes implemented in previous years. At the same time, current government spending remained high due to the effect of automatic stabilisers, wage reform and the impact of stimulus measures. Discretionary fiscal-policy measures that had a direct impact on deficit expansion were mainly targeted at the labour market and tax breaks, support of research and development, and financing of small and medium-sized enterprises. Conversely, deficit growth was held back with increases in excise duty. Discretionary measures were deployed on a small scale, mainly due to budgetary restrictions, but also because of the relatively limited efficiency of large-scale measures in an open economy.

***Slovenia is still among the euro-area countries with relatively low debt levels, but the speed of last year's debt increase, and the projected rise this year and next, lends urgency to consolidation if a deterioration of the perception of Slovenia on financial markets is to be prevented.*** Amidst the economic downturn, general government debt soared in 2009, mainly as a result of a high deficit and front-loaded borrowing by the treasury to finance the deficit in 2010. Measured by debt and interest as a share of GDP, Slovenia is still one of the least indebted EU countries, but its relative debt increase was among the highest in the EU last year. During the crisis, Slovenia managed to maintain its credit rating, while the yield to maturity of government bonds was significantly lower than in high-risk countries. To retain its sovereign rating and preclude a worsening of the perception of Slovenia on the financial markets, it is vital that fiscal policy ensures that borrowing conditions remain at the present level with consistent consolidation of public finances. Only in this way can Slovenia dam the growth of debt-servicing costs and the crowding-out effect on other government expenditure. This would also have a positive impact on the borrowing conditions of private-sector players on the financial market.

***Public finances will not start to improve in 2010, making achievement of stability by 2013 an even more challenging task.*** The proposed supplementary budget for 2010 does not include expenditure-side cuts achieved with more systemic measures, it only matches expenditure with lower projected revenue; therefore this year the budget will not contribute to the consolidation of public finances. On the revenue side, the supplementary budget, much like the adopted budget for 2010, relies heavily on EU funds and higher excise revenue, neither of which can structurally plug the budget gap. These trends confront fiscal and economic policy-makers with the challenge of realising the Stability Programme objective of bringing the deficit down to 1.6% of GDP in 2013. Consolidation must therefore start as soon as possible, and be conducted in a manner that ensures sustainability of public finances. This is urgent because of the widening current deficit and the pressure on expenditure exerted by an ageing population, which will start to increase more rapidly in the coming years, as well as the relatively high scope of public guarantees, which are a potential liability, and represent a risk of a rapid increase in debt should they be called. Deficit-cutting measures must start as soon as possible, in particular structural measures that will reduce the general government deficit in a sustainable way, i.e. preserve a stable structural fiscal position on a

more sustainable basis. Without these reforms, other macroeconomic balances could collapse: the risk of inflation would increase and borrowing conditions on the international financial markets would tighten.

**On the revenue side, the scope to increase taxes is limited.** Higher rates of taxes on labour and capital would have an adverse impact on economic activity and competitiveness, which, particularly in a period of slow and uncertain recovery, would have a dampening effect on the economy. In deciding on measures to increase revenue in these areas, it would be wise to consider solutions that would not put any additional burden on labour and capital. Tax-policy measures must focus on improving tax capacity by preserving tax rates and expanding the tax base with elimination of the current distortions (e.g. student work), simplifying tax procedures to reduce the scope of tax evasion and consequently of the grey economy, and improving the information system by introducing uniform records and ensuring better oversight. The introduction of a cap on the base for social-security contributions could also have a positive long-term impact on competitiveness and, by extension, revenue. In the short term, however, capping social-security contributions would reduce revenue, which would not be sustainable. The resulting revenue shortfall would have to be replaced with other sources, primarily an expansion of the tax base. There is still scope to ensure more stable revenue through taxation of consumption. It would make sense to undertake a transition towards raising indirect taxes, which are far less affected by the economic cycle, while keeping in mind the impact on the increase of general price levels. In excise duty, in particular excise on fuels for transportation, it is however necessary to take into account the potential drop in consumption. It is preferable to raise excise on products with relatively low elasticity of demand.

**Despite last year's improvement in the drawing of EU funds, additional efforts are needed to realise the Stability Programme objectives in this field.** Following two years of modest drawing of EU funds, Slovenia was once again a net recipient last year, due to measures at EU and national level. The drawing of funds according to the financial perspectives may vary from year to year, but to increase absorption capacity, it is vital to ensure the quality of proposed projects as well as the preparation and implementation of tenders, and improvements will have to be made in this area in the coming years. This will be of particular importance given that the Stability Programme – Update 2009 makes EU funds an important element of the consolidation of public finances in the coming years. Failure to realise the set objectives would pose a significant risk to the success of the deficit reduction process; it could affect the dynamics of investment activity and hence the speed of economic recovery.

**Liabilities for debt servicing are a fast-growing segment of expenditure and in the consolidation process they will limit and crowd out expenditure for other purposes; our estimates suggest that expenditure with higher development potential will decrease in this year.** The structure of expenditure by function highlights a renewed increase in the share of expenditure for public administration due to higher debt-servicing liabilities, a trend that will continue in the coming years. Considering the urgency of curbing the growth of total expenditure in the process of consolidation, such projections mean that expenditure on public administration will limit and crowd out expenditure on other functions, including spending on social protection, health, education and economic activities, which in relative terms had been comparable to that in similarly developed countries in 2008. Analysis of expenditure by programming structure does show that measures to mitigate the consequences of the economic and financial crisis were the main driving forces of the ballooning expenditure on development policies. However, in the adopted budget for 2010 a reduction was already planned, and our estimate shows that it will be further cut in the supplementary budget for 2010 (December 2009). In last year's budget for 2010, a step towards greater consideration of development priorities was undertaken with the adoption of a programme-based budget, which changes the underlying logic of budget planning by putting national development priorities foremost. However, the 2010 supplementary budget was not structured to match these programme priorities, which interrupted, at a very early stage, the process of qualitative change in budgeting that was supposed to form the basis of a restructuring of expenditure towards greater emphasis on development.

**General government expenditure can be partially reduced through savings and streamlining, but there is insufficient scope here to achieve sustainable consolidation.** Expenditure savings can be made through consistent implementation of measures to improve the efficiency of the public sector and with rationalisation, as stipulated in the Stability Programme and Slovenian Exit Strategy 2010–2013. Implementing the planned measures to curb employee remuneration is especially important here. Given that employment growth in the

general government sector was not halted this year, achieving the set objectives will require additional efforts in the years ahead, restricting employment while considering actual needs and pursuing the goal of maximising efficiency, as well as efforts in wage policy. Considerable savings can also be made by improving the efficiency of the public-procurement system.

***A broader and consistent solution to reducing total expenditure as a share of GDP lies in restructuring expenditure with structural reforms geared towards strengthening the role of development expenditure earmarked for promoting competitiveness, and maintaining the long-term sustainability of public finances.***

It is vital to consistently implement programme-based budgeting and to exclude inefficient programmes, sub-programmes and measures of public financing from individual functions and policies. Restructuring also makes it possible to reduce expenditure on otherwise efficient economic activities, by curbing and reforming spending on agriculture and scaling back state aid to troubled companies and old industries. In financial support of entrepreneurship, measures are needed for better promotion of small enterprises as the most dynamic part of the economy, which should support a change in the structure of the economy. Efficiency can also be improved in other areas of expenditure that contribute to competitiveness, especially spending on research and education. In financing public investments, which are crucial for economic activity, it is necessary to make a transition to the financing predominantly with EU funds envisaged by the Stability Programme and the Exit Strategy, and to consider strengthening public-private partnership. In social protection, savings can be made by improving the efficiency of social policy and better tying social transfers to social status, as is also envisaged in the Exit Strategy. In the provision of individual public services, in particular, it is advisable to shift part of the burden onto the private sector.

***The long-term sustainability of the public finances will crucially depend on systemic adjustments of social-protection systems and on economic-policy measures that will raise potential economic growth rates.***

The key factor determining the state of the public finances over the medium and long term is the changing demographic structure of the population. It is therefore essential to undertake key systemic changes in the provision of social security, and to consistently implement economic-policy measures that will increase potential GDP growth rates. The planned adjustments of social-protection systems must be carried out before expenditure related to the ageing population begins to surge. Pension reform, initially a change of the valorisation mechanism, followed in the shortest possible time by a comprehensive modernisation of the pension system, will slow the growth in pension expenditure and postpone retirement. Additionally, pressure on expenditure growth will be alleviated by reform of health care and long-term care. These reforms are already planned in both of the government documents mentioned previously, and it is now crucial that they be adopted as soon as possible and implemented in a comprehensive fashion.

***The introduction of the fiscal rule can buttress the consolidation process, but it is essential that it be well designed and consistently adhered to.***

It is sensible to introduce the fiscal rule as part of the consolidation of public finances, as shown by the examples of best practice offered by other countries. However, the key parameters of the fiscal rule should be adapted to the country's specifics, in particular the starting position and pressures on the long-term sustainability of public finances. In the process of consolidation, an expenditure fiscal rule, which is also proposed by the Stability Programme, should be relatively restrictive, representing a framework within which expenditure is reoriented towards development and ensuring the long-term sustainability of public finances. What is important is that stable financing sources are provided in this period. In particular, however, the rule must be consistently applied in budgeting; even the best economic policy rule is efficient only if it is observed.

***Sale of state shareholdings and better management of state-owned property can contribute to consolidation to a certain extent.***

Through ownership shares in companies, the state can support fiscal consolidation, in particular by improving management, allowing these companies to develop and raise capital and, by extension, boosting the annual income generated. For this to happen, it is necessary to open up the shareholder structure and allow these companies to raise capital. The scope for reducing public debt by selling off ownership stakes held by the state is limited in our view; for many of the companies directly owned by the Republic of Slovenia, it will be difficult to reach political consensus on what proportion of shares should be sold. There are also many companies that perform general public services and are therefore not expected to be privatised. Several of these are unlikely to attract investor interest and some are already in the process of liquidation. The Exit Strategy objective to reduce public debt by 2 p.p. by selling state-owned property is realistic, but in political and economic terms it is not necessarily one that can be easily achieved.



## Introduction

***As the financial and economic crisis deepened, public finances experienced a significant deterioration.*** In 2009, the general government deficit widened substantially due to negative cyclical effects of recession and the consequences of past fiscal-policy measures and stimulus measures, which accelerated the growth of public debt and liabilities for debt-servicing. In 2010, the public finances will not improve, confronting fiscal policy with the challenge of consolidating public finances in the shortest possible time and in a sustainable manner. Balancing the public finances with fiscal-policy measures supported by other economic policies is vital to create a stable macroeconomic framework to provide conditions for faster economic growth and to ensure sustainability of public finances over the medium and long term, when expenditure related to the ageing population will start to balloon. Without this, other macroeconomic balances could collapse: the risk of inflation would increase and borrowing conditions on the international financial markets worsen.

***In this year's fiscal chapter, emphasis has been placed on analysis of the fiscal position and the scope for consolidation of public finances.*** The first part presents last year's fiscal trends in the EU and changes in fiscal aggregates and flows in Slovenia, including an analysis of cyclical and structural factors, financial flows between Slovenia and the EU budget, public debt and elements of long-term sustainability of the public finances. The second part includes a detailed analysis of revenue and expenditure and an assessment of possibilities for the restructuring thereof. Additionally, three topics were singled out: effectiveness of state aid, the role of the fiscal rule in ensuring fiscal stability, and sale and management of ownership stakes of the state as an opportunity for consolidation of the public finances. Finally, based on all the analyses, possible guidelines for sustainable consolidation of the public finances that may make it possible to preserve and strengthen their development role are provided.

## Part I

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### 1. Fiscal Development and Policy in the EU

***Slowdown in economic activity resulting from the global financial and economic crisis, and fiscal measures taken to combat the crisis, led to substantial deterioration of public finances in euro-area and EU countries in 2009.*** The general government deficit of euro-area countries, which averaged 0.6% of GDP in 2007, the lowest in years, started to rapidly widen in 2008 as the financial and economic crisis escalated. By 2008, it had risen to 2.0% of GDP and in 2009 it soared to 6.3% of GDP. Data on cyclically adjusted general government balances indicate that the improvement in 2007 was primarily a result of favourable economic conditions and to a lesser extent of fiscal-policy measures, hence the relatively rapid deterioration when the financial and economic crisis deepened. In its Spring Forecast 2010, the European Commission does not expect an improvement in public finances in the euro area or the EU in 2010 despite the projected gradual recovery of economic activity. The average general government deficit in the euro area is thus projected to widen to 6.6% of GDP this year, with a gradual improvement not expected before 2011, when it is set to narrow to an average of 6.1% of GDP. The EC projects a similar dynamic for the entire EU, where general government deficit swelled to 6.8% of GDP last year from 2.3% in 2008 and is forecast to widen to 7.2% of GDP this year before dropping to 6.5% next year.

***Most EU countries have been in the excessive-deficit procedure since last year.*** Public finances experienced severe deterioration in almost all EU Member States in 2009, putting twelve into excessive-deficit procedures by the end of that year. According to EC forecasts, only three Member States will not breach the 3% of GDP deficit ceiling prescribed by the EC Treaty and the Stability and Growth Pact. For most Member States, the EC set 2012 or 2013 as the deadline for bringing their deficits back below the reference value. Countries subject to excessive-deficit procedures provide regular progress reports to the EC on measures to consolidate their public finances. In the event of unforeseen economic circumstances that significantly diverge from the estimate in the recommendation for correction of excessive deficit, the deadline may be extended. In any case, provisions of the Stability and Growth Pact determine that

Table 1: Actual and cyclically adjusted general government balances in EU countries

	Actual balance (% of GDP)						Cyclically adjusted balance (% of GDP)					
	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
Belgium	-2.7	0.3	-0.2	-1.2	-6.0	-5.0	-2.9	-0.4	-1.4	-2.0	-4.5	-3.7
Germany	-3.3	-1.6	0.2	0.0	-3.3	-5.0	-2.7	-2.2	-1.2	-1.5	-1.8	-3.6
Ireland	1.6	3.0	0.1	-7.3	-14.3	-11.7	-0.9	2.1	-1.6	-7.0	-11.4	-8.7
Greece	-5.2	-3.6	-5.1	-7.7	-13.6	-9.3	-5.6	-4.7	-7.0	-9.6	-14.1	-8.2
Spain	1.0	2.0	1.9	-4.1	-11.2	-9.8	1.0	1.6	1.2	-4.4	-9.6	-7.8
France	-2.9	-2.3	-2.7	-3.3	-7.5	-8.0	-3.4	-3.0	-3.7	-3.7	-6.2	-6.6
Italy	-4.3	-3.3	-1.5	-2.7	-5.3	-5.3	-4.6	-4.4	-3.0	-3.3	-3.3	-3.6
Cyprus	-2.4	-1.2	3.4	0.9	-6.1	-7.1	-2.2	-1.3	2.5	-0.4	-5.8	-6.3
Luxembourg	0.0	1.4	3.6	2.9	-0.7	-3.5	-0.3	0.1	1.1	2.0	1.2	-1.4
Malta	-2.9	-2.6	-2.2	-4.5	-3.8	-4.3	-2.5	-2.5	-2.5	-4.9	-3.1	-3.8
Netherlands	-0.3	0.5	0.2	0.7	-5.3	-6.3	0.3	0.3	-1.0	-0.5	-3.6	-4.9
Austria	-1.7	-1.5	-0.4	-0.4	-3.4	-4.7	-1.3	-1.9	-1.6	-1.7	-2.4	-3.6
Portugal	-6.1	-3.9	-2.6	-2.8	-9.4	-8.5	-5.7	-3.7	-3.0	-2.9	-8.3	-7.5
Slovenia	-1.4	-1.3	0.0	-1.7	-5.5	-6.1	-1.6	-2.6	-2.9	-4.8	-3.8	-4.4
Slovakia	-2.8	-3.5	-1.9	-2.3	-6.8	-6.0	-2.5	-3.9	-3.7	-4.5	-6.4	5.4
Finland	2.8	4.0	5.2	4.2	-2.2	-3.8	2.6	2.8	2.6	2.1	0.3	-1.4
EMU-16	-2.5	-1.3	-0.6	-2.0	-6.3	-6.6	-2.5	-2.0	-1.9	-2.9	-4.8	-5.1
Bulgaria	1.9	3.0	0.1	1.8	-3.9	-2.8	0.8	1.7	-1.5	0.0	-2.8	-1.1
Czech Rep.	-3.6	-2.6	-0.7	-2.7	-5.9	-5.7	-3.9	-4.0	-2.9	-4.5	-5.1	-4.7
Denmark	5.2	5.2	4.8	3.4	-2.7	-5.5	4.7	3.5	3.1	3.3	0.6	-3.0
Estonia	1.6	2.5	2.6	-2.7	-1.7	-2.4	0.3	0.0	-0.7	-4.1	1.3	0.2
Latvia	-0.4	-0.5	-0.3	-4.1	-9.0	-8.6	-1.5	-3.2	-4.5	-6.4	-6.3	-5.7
Lithuania	-0.5	-0.4	-1.0	-3.3	-8.9	-8.4	-1.8	-2.1	-3.7	-5.7	-6.7	-6.1
Hungary	-7.9	-9.3	-5.0	-3.8	-4.0	-4.1	-8.7	-10.9	-6.4	-5.1	-2.2	-2.1
Poland	-4.1	-3.6	-1.9	-3.7	-7.1	-7.3	-3.9	-4.0	-2.8	-4.6	-6.9	-6.5
Romania	-1.2	-2.2	-2.5	-5.4	-8.3	-8.0	-2.2	-4.1	-4.7	-8.2	-7.8	-6.9
Sweden	2.3	2.5	3.8	2.5	-0.5	-2.1	1.0	0.3	1.6	1.4	1.9	-0.2
U. K.	-3.4	-2.7	-2.8	-4.9	-11.5	-12.0	-4.0	-3.5	-3.9	-5.7	-9.7	-10.4
EU-27	-2.5	-1.4	-0.8	-2.3	-6.8	-7.2	-2.6	-2.2	-2.1	-3.2	-5.2	-5.6

Source: European Commission.

Note: The EC estimate of the cyclically adjusted balance for Slovenia, in particular for 2008, differs from IMAD estimates (see Section 2.1). The difference is partially attributed to differences in production functions and partially to different forecasts. The difference is biggest in 2008, a consequence, we assume, of different estimates of potential output (see also Appendix 1).

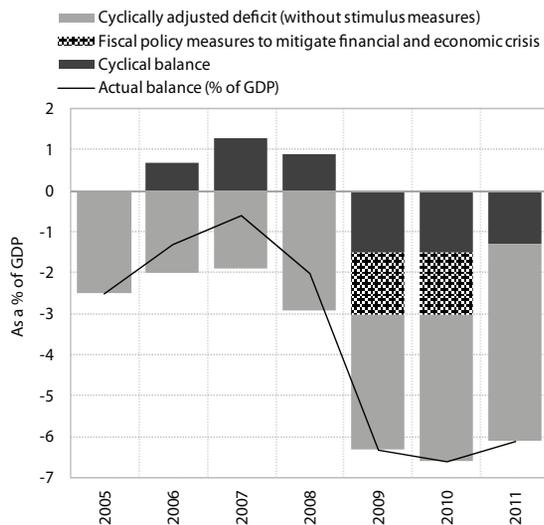
sanctions<sup>1</sup> are introduced against countries which do not correct excessive deficits in the given period.

<sup>1</sup> If a Member State in the excessive-deficit procedure does not take action on two consecutive decisions by the EU Council, a Council decision on the introduction of sanctions is adopted in 16 months from the reporting date. The first deposit by the participating Member State comprises a fixed component equal to 0.2% of GDP and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the year in which the deficit was deemed to be excessive and the reference value of 3% of GDP. Each year until the abrogation of the excessive-deficit decision, the Council assesses whether the Member State has adopted effective measures. In this annual estimate, the Council decides to intensify sanctions unless the participating Member State has acted in accordance with the Council resolution. If an additional deposit is required, it is equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference

**The average general government debt in the euro area and the EU rose rapidly in 2009 due to high deficits and large-scale measures in support of the financial sector that were financed with government borrowing.** In 2009, general government debt in the euro area increased by an average of 9.3% p.p. to 78.7% of GDP (by 12 p.p. in the EU), and according to EC forecasts it will rise by a further 6.6 p.p. in 2010 to reach nearly 85% of GDP in the euro area and just under 80% of GDP in the EU. Besides primary deficits, which remain high after last year's increase, public debt is also being affected by growing expenditure on debt servicing and the financing of numerous off-budget expenditure that Member States have

value of 3% of GDP. Individual deposits may not exceed the upper limit of 0.5% of GDP per year.

Figure 1: Deficit composition of euro-area countries, as % of GDP



Source: European Commission.

allocated to ensure stability of the financial system as part of stimulus measures, in particular the supply of capital to financial firms. According to EC estimates, funds spent on bank capital injections in the EU that directly increased public debt amounted to 2% of GDP last year. On top of measures that directly increased debt, many Member States last year issued extensive guarantees in conformity with existing state aid rules, which has continued this year and which increases potential state liabilities if the guarantees are called. The EC estimates that total outstanding guarantees to the financial sector until March this year averaged just over 28% of GDP in the EU.

**Portugal, Spain, Italy, Ireland and, in particular, Greece stand out among the countries whose finances are in a much worse state than the euro area on average. Indeed, in early 2010, Greece requested financial aid in the amount of EUR 110 bn as the situation on financial markets deteriorated.**

At the beginning of this year, the yield to maturity of government bonds of certain Member States with relatively weak fiscal positions (Greece in particular, but also Portugal, Spain and Ireland) started to widen and the euro came under pressure from the financial markets. Among the Member States that experienced severe deterioration of public finances in 2009, the situation escalated most at the start of this year in Greece, which is a special case in this group because of tampering with data on the state of its public finances. General government debt in Greece had already surged in 2008, when it was the highest in the EU (7.7% of GDP). In April 2009, the Greek debt and deficit report provided a much lower estimated

Table 2: General government debt, as % of GDP

	2005	2006	2007	2008	2009	2010
Belgium	92.1	88.1	84.2	89.8	96.7	99.0
Germany	68.0	67.6	65.0	66.0	73.2	78.8
Ireland	27.6	24.9	25.0	43.9	64.0	77.3
Greece	100.0	97.8	95.7	99.2	115.1	124.9
Spain	43.0	39.6	36.2	39.7	53.2	64.9
France	66.4	63.7	63.8	67.5	77.6	83.6
Italy	105.8	106.5	103.5	106.1	115.8	118.2
Cyprus	69.1	64.6	58.3	48.4	56.2	62.3
Luxembourg	6.1	6.5	6.7	13.7	14.5	19.0
Malta	70.2	63.7	61.9	63.7	69.1	71.5
Netherlands	51.8	47.4	45.5	58.2	60.9	66.3
Austria	63.9	62.2	59.5	62.6	66.5	70.2
Portugal	63.6	64.7	63.6	66.3	76.8	85.8
Slovenia	27.0	26.7	23.4	22.6	35.9	41.6
Slovakia	34.2	30.5	29.3	27.7	35.7	40.8
Finland	41.8	39.7	35.2	34.2	44.0	50.5
EMU-16	70.1	68.3	66.0	69.4	78.7	84.7
Bulgaria	29.2	22.7	18.2	14.1	14.8	17.4
Czech Rep.	29.7	29.4	29.0	30.0	35.4	39.8
Denmark	37.1	32.1	27.4	34.2	41.6	46.0
Estonia	4.6	4.5	3.8	4.6	7.2	9.6
Latvia	12.4	10.7	9.0	19.5	36.1	48.5
Lithuania	18.4	18.0	16.9	15.6	29.3	38.6
Hungary	61.8	65.6	65.9	72.9	78.3	78.9
Poland	47.1	47.7	45.0	47.2	51.0	53.9
Romania	15.8	12.4	12.6	13.3	23.7	30.5
Sweden	51.0	45.7	40.8	38.3	42.3	42.6
U. K.	42.2	43.5	44.7	52.0	68.1	79.1
EU-27	62.7	61.4	58.8	61.6	73.6	79.6

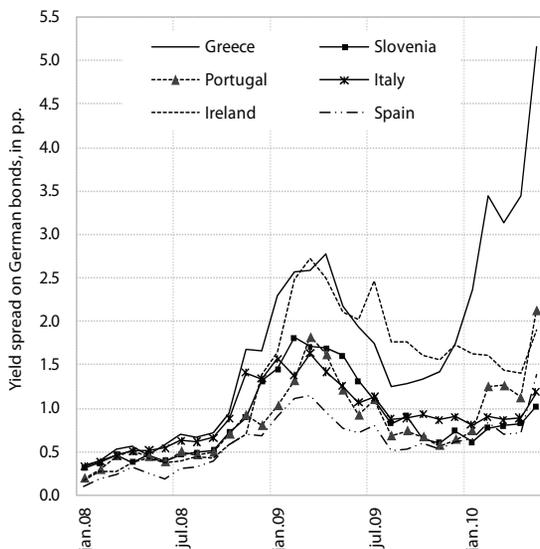
Source: European Commission.

deficit for 2009 (3.7% of GDP). In the next notification, in October 2009, Greece reported a substantially higher deficit, 12.5% of GDP, but Eurostat rejected the report in January 2010, expressing suspicion that Greece's fiscal data had been doctored; In April, it released an estimate that put the deficit at 13.6% of GDP. Greece's already precarious status on the international financial markets relative to other euro-area countries took a severe blow after the release, and the yield to maturity of Greece's 10-year bonds soared. With increasing fiscal woes and growing problems securing funding to cover the deficit and repay loans due this year, Greece addressed an official request for financial aid to the Eurogroup, EC and ECB on 23 April 2010. The EC, ECB and IMF provided an estimate of necessary funds for Greece, amounting to EUR 110 bn over three years, and proposals for accompanying economic-policy measures. To gain access to financial aid, the Greek authorities pledged to carry out

economic-policy measures laid out in a Memorandum of Understanding. The underlying objective of these measures is to consolidate the public finances and reduce general government deficit to 2.6% of GDP in 2014, which would stabilise general government debt at a level reached in 2013, followed by a gradual reduction.<sup>2</sup> At the end of April 2010, the EC, ECB and IMF assessed the proposed Greek consolidation measures until 2014 positively, taking the formal decision to launch the aid mechanism. Over three years, euro-area countries will contribute EUR 80 bn, with the share of each creditor equal to its share in the ECB's capital. Nearly 80% of the aid will be provided by the four biggest euro-area countries (Germany EUR

22.4 bn, France 16.8 bn, Italy EUR 14.7 bn and Spain EUR 9.8 bn). Slovenia's proportional share amounts to 0.49% or EUR 387 m over three years, of which EUR 145 m is due in 2010 and EUR 242m in the next two years. Under the agreement between Greece and the EC, IMF and ECB, implementation of the proposed measures, which will be monitored quarterly, is the principal condition for the phasing of the loans.

Figure 2: Yield to maturity spreads on 10-year government bonds relative to German bonds, in p.p.



Source: Eurostat.

<sup>2</sup> Measures planned for 2010 include raising the general VAT rate from 21% to 23%, increasing excise duty on fuels, alcohol and tobacco, curbing remuneration for employees in the public sector and pension expenditure, and reducing the scope of investments financed with budgetary funds. In the coming years revenue-side measures to be taken include expansion of the tax base, additional taxation of consumption and capital, introduction of ecological taxes and disinvestment of state-owned assets. On the expenditure side, measures are focused on restrictive employment and wage policies in the public sector, streamlining of government spending, freezing of pensions, improving absorption of EU funds and increasing their share in the financial structure of investments, and reducing transfers to public utilities and public institutions. Fiscal measures are coupled with structural reforms on the labour market (wage adjustment, simplifying the establishment of companies, licensing of professions, etc.) in the pension and health-care sectors, in public administration and in the business environment. Furthermore, the programme requires that the Greek central bank establish on behalf of the government a special EUR 15-bn financial-stability fund, which will provide reserves to ensure capital adequacy of the banking system.

**Given the risk of the crisis spreading to other EMU countries and the drop in the value of the euro, euro-area countries, along with the ECB and the IMF, adopted additional emergency measures.**

To prop up the euro, agreement was reached to establish a system of aid that includes expansion of the existing European balance-of-payments facility from countries without the euro to EMU countries and increasing this to EUR 60 bn; activation of these resources will be subject to a variety of conditions in the context of joint EU and IMF aid, and under conditions similar to those that the IMF sets for financial aid to affected countries. Moreover, euro-area countries will supplement these funds with a three-year mechanism of bilateral loans modelled on the Greece mechanism – proportional and co-ordinated. The mechanism involves establishment of a facility that will assume debt of up to EUR 440 bn with the guarantees of EMU countries. Fundamental changes were also undertaken as regards the ECB's monetary policy, which most probably prevented the crisis from escalating. The ECB took two steps to mitigate the crisis. Firstly, it abandoned its exit strategy of phasing out liquidity measures by increasing funding to commercial banks<sup>3</sup> and, in co-operation with the Fed, re-establishing refinancing operations in US dollars. Secondly, it opted to directly purchase government and private debt, a measure coupled with additional sterilisation, which it explained with confidence in countries' commitment to adhere to fiscal goals and their readiness to accelerate fiscal consolidation where necessary.

**Greece's case highlighted the weaknesses of the existing mechanism for co-ordination of economic policies in the euro area.**

It showed that the present mechanisms for fiscal-policy co-ordination, enshrined in the Stability and Growth Pact, fail to ensure sufficient fiscal discipline in a downturn. As the deterioration of public finances spilled over from one country to all euro-area members, it became clear that the present

<sup>3</sup>Six-month operation of long-term refinancing with full allotment at interest determined as average benchmark interest in main refinancing operations during the duration of this operation (EUR 36 bn was allotted until 12 May); implementation of three-month long-term refinancing operations (26 May and 30 June) in auction format with fixed interest and full allotment.

mechanism is too loose and not binding enough to preserve currency stability. The solutions that launched the Greece aid mechanism, the agreement to set up a permanent EU system to guarantee stability of the euro and the ECB abandoning its own principles of preserving price stability as the primary objective of euro-area monetary policy, were urgent in the circumstances to prevent destabilisation of the euro area – especially given the fact that several euro-area countries have high deficits and/or debt and uncertain prospects of economic recovery, which could have an adverse impact on their position on financial markets and further undermine the stability of the entire euro area. However, these agreements do not amount to a long-term solution; achieving that will require systemic adjustments and changes to the institutional framework of the EMU. At EU level, a special group under the leadership of the EU president was formed in May 2010, tasked with supplementing the existing fiscal framework with a package of recommendations in three areas: crisis prevention, crisis mitigation and crisis resolution. On crisis prevention, recommendations include strengthening the preventive arm of fiscal-policy co-ordination by harmonising the budgeting cycle across the euro area, increasing the importance of public debt and the sustainability thereof in the framework of excessive-deficit procedures, and beefing up structural reforms. The proposed measures also include sanctions against Member States that fail to make headway in implementation of mid-term objectives. On crisis mitigation, the proposal includes an accelerated introduction of sanctions against Member States that regularly breach provisions of the Stability and Growth Pact, including suspension of cohesion payments and conditionality in the drawing of funds from the EU budget. On crisis resolution, it has been proposed that in the event that crisis-prevention measures are inadequate, a Member State may be eligible for financial assistance in the form of loans. The latter should be subject to rigorous conditions regarding the policies Member States must implement to tackle the underlying imbalances.

## 2. Budget aggregates of the general government sector (ESA95) in 2009

***The imbalance in the public finances worsened substantially in 2009, largely as a result of the fallout from the financial and economic crisis.*** The general government deficit<sup>4</sup> is estimated at 5.5% of GDP, up 3.8 p.p. on 2008. Government revenue increased by 1.8 p.p. in relative terms but expenditure rose 5.6 p.p. of GDP.<sup>5</sup> Revenue declined as a result of the deterioration of the macroeconomic environment amidst the economic and financial crisis, and the effects of the tax changes implemented in the previous years. At the same time, current government spending remained high due to automatic stabilisers as well as the effects of the wage reform and the impact of stimulus measures (see also Figure 3). The fiscal position started to deteriorate in the second half of 2008, a trend that accelerated in the first half of 2009, when revenue dropped but expenditure remained at a high level. Expenditure growth did not slow until the second half of 2009, when the deficit dropped to 4.5% of GDP from 6.5% in the first half of that year. Despite a significant deterioration of the budgetary position in 2009, the increase of the general government deficit was lower in relative terms than the average for the EU and the euro area (see Section 1).

***Although nominal revenue dropped in 2009, it increased by 1.8 p.p. as a share of GDP because nominal GDP declined more.***<sup>6</sup> But despite the 1.9% nominal drop in revenue, the burden of taxes and social-security contributions as a share of GDP rose by 1.3 p.p. and total general government revenue by 1.8 p.p. as overall GDP contracted even faster (-6% in nominal terms). Among the key categories, revenue from social-security contributions increased by 1.1 p.p. year-on-year. Taxes on production and imports dropped as a result of the slowdown in economic activity and abolition of the payroll tax, in spite of increases in excise duties and higher excise revenue, but their share rose by 0.2 p.p. Current taxes on income and property dropped as personal and corporate income-tax receipts declined, but they remained unchanged as a share of GDP. Corporate income-tax revenue declined due to poorer company results as well as legislative changes

<sup>4</sup> ESA95 methodology, Report on government debt and deficit, April 2010

<sup>5</sup> The increase in the share of aggregates in 2009 was substantially affected by the economic contraction.

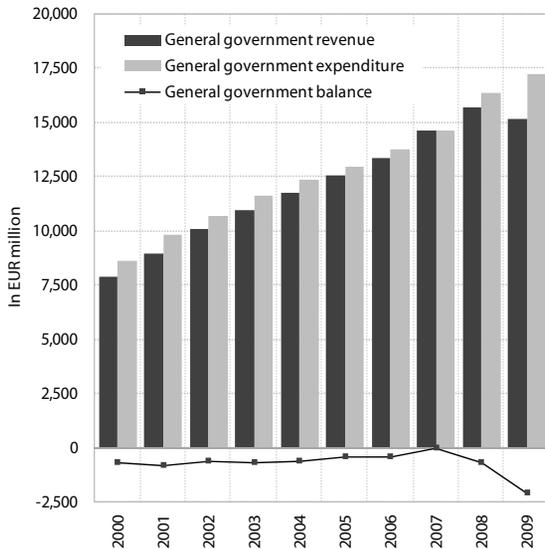
<sup>6</sup> Even though nominal revenue declined, its share of GDP increased since GDP contracted even more quickly in 2009.

Table 3: Revenue, expenditure and balance of the general government sector, as % of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total general government revenues	43.0	43.6	43.9	43.7	43.6	43.8	43.2	42.4	42.6	44.4
Total general government expenditure	46.7	47.6	46.3	46.4	45.8	45.2	44.5	42.4	44.3	49.9
Net lending (+) / net borrowing (-)	-3.7	-4.0	-2.5	-2.7	-2.2	-1.4	-1.3	0.0	-1.7	-5.5

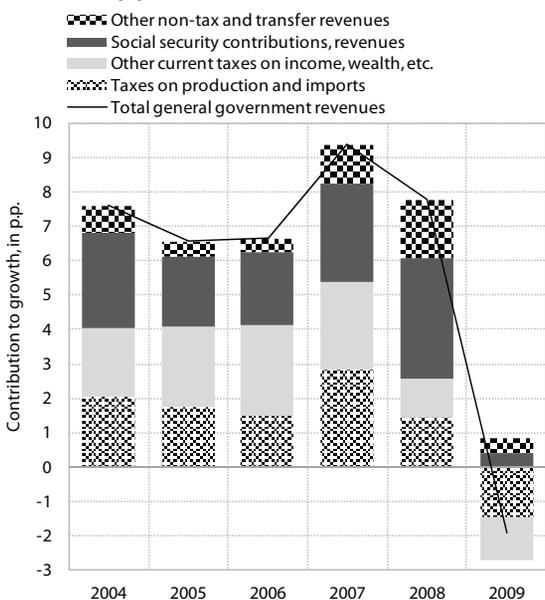
Source: SORS, Basic aggregates of the general government, First release, 31 March 2010 (for 2006–2009). Non-financial accounts: general government 5-13, IMAD calculations

Figure 3: Revenue, expenditure and balance of the general government sector



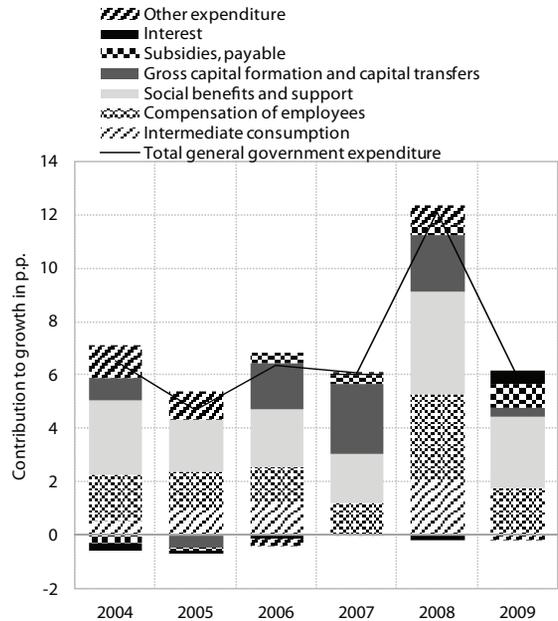
Source: Basic aggregates of the general government, First release, 31 March 2010 (for 2006–2009). Non-financial accounts: general government 5-13

Figure 4: Contribution to growth of general government revenue, in p.p.



Source: SORS, Basic aggregates of the general government, First release, 31 March 2010 (for 2006–2009). Non-financial accounts: general government 5-13, IMAD calculations.

Figure 5: Contribution to growth of general government expenditure, in p.p.



Source: SORS, Basic aggregates of the general government, First release, 31 March 2010 (for 2006–2009). Non-financial accounts: general government 5-13, IMAD calculations

that reduced the tax rate and expanded tax relief, while income-tax revenue was affected by additional general relief in the lowest income brackets. Other (non-tax) revenue rose by 0.5 p.p.

**General government expenditure surged in 2009, and it also jumped in relative terms given the nominal drop in GDP.** Nominal expenditure rose 6%, but as a share of GDP it was up 5.7 p.p. over the previous year. The share of social benefits and support in cash and in kind increased most in 2009 (by 2.3 p.p.) as automatic stabilisers kicked in when the labour market deteriorated. Higher employee remuneration increased expenditure by 1.5 p.p. due to the wage reform and the growing ranks of public-sector employees. As a consequence of stimulus measures, subsidies as a share of GDP rose by 0.6 p.p. and expenditure on intermediate consumption and capital formation by 0.5 p.p. each. Interest expenditure was up 0.3 p.p. as government borrowing expanded and interest rose. Other expenditure did not increase significantly in relative terms over the year before.

Table 4: General government revenue, expenditure and balance according to ESA95, as % of GDP, Slovenia, 1995–2009

	1995	2000	2005	2006	2007	2008	2009
General government deficit	-8.5	-3.7	-1.4	-1.3	0.0	-1.7	-5.5
Central government	-7.9	-3.2	-2.2	-1.3	-0.1	-1.1	-4.6
Local government	0.2	0.0	0.0	-0.1	-0.1	-0.6	-0.5
Social security funds	-0.8	-0.5	0.8	0.1	0.2	0.0	-0.4

Source: SI-STAT Data Portal – Economy – National accounts – Main aggregates of the general government, First release (SORS), 31 March 2010 (for 2006–2009). Non-financial accounts: general government 5-13; IMAD calculations (for 1995, 2000, 2005).

**The general government deficit was generated primarily at the central level, much as it was in the years before, but the deficits of the local government and social-security funds were also relatively high compared with the previous period.**

In 2009, central government accounted for almost 84% of the total deficit. The local-government deficit rose in 2008 and in 2009 remained above the levels recorded in the previous years (0.5% of GDP) despite a relative drop (by 0.1 p.p.). The biggest factors behind the growth of central-government expenditure were capital formation and capital transfers, which contributed nearly half the growth in the 2007–2009 period. In local government, capital formation and capital transfers account for over a quarter of total expenditure; they have also been growing at above-average rates, as investment activity at local level was promoted after 2006 with an expansion of borrowing options and later with EU funds. Growth of local-government expenditure was also underpinned by the compensation of employees, which accounted for about 30% of total growth in 2006–2008 and over 40% in 2009. Expenditure on intermediate consumption also had a significant impact on overall expenditure, contributing a quarter of the growth in the election year, 2006, and almost 19% in 2008. The first deficit (0.4% of GDP) since 2004 was also recorded for social-security funds.

## 2. 1. Analysis of cyclically adjusted balance

**Analysis of the cyclically adjusted balance is a tool for assessing the orientation and appropriateness of fiscal policy, but it should be used with caution in making economic policy given the changing estimates of potential output and the impact of revisions of data for previous years.** It provides an additional insight into the impact of past fiscal-policy measures, which can contribute to ex-post estimates of fiscal-policy orientation and determination of the causes of imbalances in the past. But in analysing the cyclically adjusted balance, caution is advised in interpreting the fiscal-position estimate and using it as the basis for economic policy, given the volatility

of potential growth and output-gap estimates, in particular in times of crisis (see Appendix 1). Moreover, revisions of economic-growth estimates and basic aggregates of general government, and the resulting changes in output-gap estimates, may alter the estimate of the fiscal state retroactively (one example is the estimate of the cyclical orientation of fiscal policy in Slovenia in 2007: according to last year's estimates, it was restrictive and counter-cyclical<sup>7</sup>, but this year's calculations, based on updated data, estimate it as mildly expansionary and cyclical).

**At the end of 2008 and in 2009, as the economy experienced a savage contraction, the cyclical component of the deficit surged.** Whereas the increase in 2008 was clearly structural, with our estimate suggesting that the cyclically adjusted balance deteriorated by 2.3 p.p., the cyclical component

Table 5: Actual, cyclical and cyclically adjusted general government balance, as % of GDP

	Actual balance (1)	Cyclical balance <sup>1</sup> (2)	Cyclically adjusted balance <sup>2</sup> (3 = 1 - 2)	Change of cyclically adjusted balance <sup>3</sup>
2000	-3.7	0.0	-3.7	-1.0
2001	-4.0	-0.3	-3.6	0.0
2002	-2.5	-0.3	-2.2	1.5
2003	-2.7	-0.8	-1.9	0.3
2004	-2.2	-0.7	-1.5	0.4
2005	-1.4	-0.7	-0.8	0.7
2006	-1.3	0.0	-1.3	-0.6
2007	0.0	1.5	-1.5	-0.2
2008	-1.7	2.1	-3.8	-2.3
2009	-5.5	-1.7	-3.8	-0.1
2010	-5.8	-1.4	-4.4	-0.5

Source: SI-Sat data portal – Economy – National accounts – Main aggregates of the general government (SORS), 2010 for the actual balance; cyclical components – IMAD calculations.

Note: <sup>1</sup>Cyclical balance indicates to what extent (and in which direction) macroeconomic conditions affected the fiscal position. It is calculated with the production-function method based on potential GDP growth estimated after the publication by SORS of GDP growth data for 2009, and the latest realisation of general government revenue and expenditure.<sup>2</sup> The cyclically adjusted or structural balance shows what fiscal position could be achieved only as the result of fiscal-policy measures, i.e. without the influence of cyclical factors. <sup>3</sup> Positive change means an improvement of the balance. Figures do not always add up because they are rounded off.

<sup>7</sup> See Economic Issues 2009, p. 46.

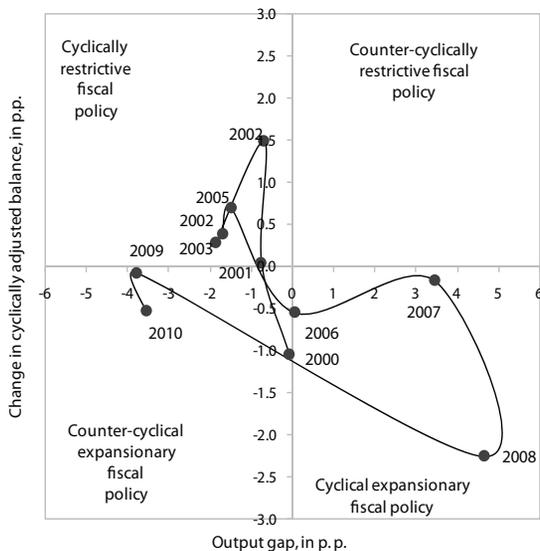
surged in 2009. According to our estimate, automatic stabilisers increased the deficit by 3.7 p.p., whereas fiscal-policy measures adopted in 2007 and 2008, and discretionary measures taken to mitigate the impact of the economic and financial crisis, contributed another 0.1 p.p. Discretionary fiscal-policy measures that had a direct impact on deficit expansion were mainly targeted at the labour market and tax breaks, support of research and development, and financing of small and medium-sized enterprises. On the other hand, deficit growth was held back with excise-duty increases. Discretionary measures were deployed on a small scale, mainly due to budgetary restrictions and the relatively limited efficiency of large-scale measures in an open economy.

**A comparison of the dynamics of the cyclically adjusted deficit and output gap shows either a cyclical or counter-cyclical orientation of fiscal policy.** Changes of the cyclically adjusted balance in consecutive years indicate the orientation of fiscal policy, i.e. the fiscal impulse. By comparing the change in the cyclically adjusted balance and output gap between individual years, which shows oscillations in the economic cycle, it is possible to assess the orientation of fiscal policy, i.e. the fiscal position. A positive fiscal impulse, for example, means an increase of the cyclically adjusted deficit in the current year compared with the year before. The varying distances of individual points from the axes shows fiscal-policy intensity. In Figure 6, there are four distinct quadrants of changes in fiscal impulse and output gap, which determine the fiscal position. Fiscal policy is counter-cyclical if the combination of both parameters lies

in the first or third quadrant. This means that when economic growth falls below its potential, fiscal policy responds in an expansionary manner; when actual growth exceeds potential GDP growth, it responds restrictively. Fiscal policy is cyclical if the combination of both parameters lies in the second or fourth quadrant. This means that when economic growth falls below its potential, fiscal policy responds restrictively; when actual growth exceeds potential GDP growth, it responds in an expansionary manner. A cyclical orientation means that fiscal policy does not allow for automatic stabilisers to operate, the result being that, for example, expenditure fluctuates not as planned but in accordance with changes in economic growth. On the revenue side, this means that when economic growth is higher than initially planned, cyclical budget revenue is used to finance tax cuts and increased expenditure, not to curb the deficit.

**After several years of being largely cyclical, fiscal policy responded mildly counter-cyclically in the crisis year of 2009 and our estimates suggest the trend will continue in 2010.** Having compared the dynamics of the cyclically adjusted balance and output gap<sup>8</sup> in the period after 2000, we estimate that fiscal policy in the 2001–2005 period was neutral in the first year, whereupon it was restrictive and cyclical, in particular in 2002. In this period, the main goal of economic policy was to fulfil the criteria to adopt the euro, which is why fiscal-policy measures, in practice targeting a deficit of 1% of GDP, dampened the activity of automatic fiscal stabilisers. Fiscal policy remained restrictive in the years when actual GDP growth was below potential, thereby keeping the general government deficit below the Maastricht ceiling. But in 2006, when the output gap turned positive due to accelerated economic growth, fiscal policy became expansionary and hence continued to act cyclically. In 2007, near the peak of the economic cycle, the cyclically adjusted balance inched higher, which had an expansionary and still cyclical effect. Calculations show that fiscal policy became even more cyclical and expansionary in 2008. The factors that contributed to looser fiscal policy included measures that accelerated the growth of expenditure (increased expenditure on investment, more funds for social transfers<sup>9</sup>, wage growth with the introduction of the new wage system

Figure 6: Cyclical orientation of fiscal policy

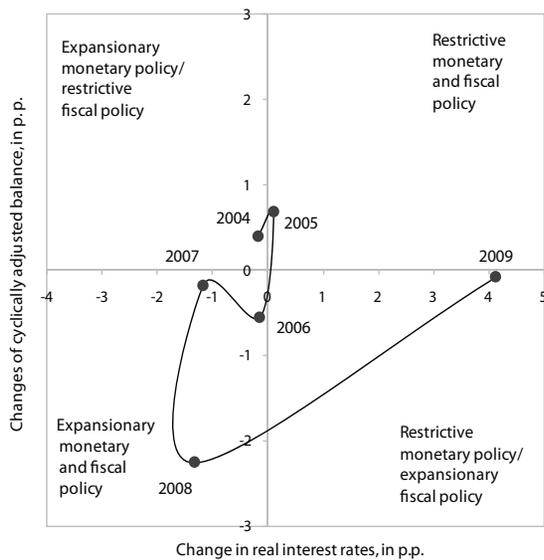


Source: SI-STAT data portal – Economy – National accounts – Main aggregates of the general government (SORS), 2010; Spring Forecast 2010 (IMAD); cyclical components – IMAD calculations.

<sup>8</sup> The output gap is assessed based on the production method used by the European Commission.

<sup>9</sup> Expenditure on social benefits and assistance to households increased substantially due to measures taken in May 2008 to alleviate the negative impact of high inflation on people's livelihood (existing measures such as subsidising of transport, food and rents, and new measures such as free meals for secondary-school children and larger kindergarten subsidies), which is probably also related to the election cycle (local elections in the autumn of 2008).

Figure 7: Combination of fiscal and monetary policy



Source: SI-Sat data portal – Economy – National accounts – Main aggregates of the general government (SORS), 2010; cyclical components for the period – IMAD calculations. Note: Real interest rates for the period 2004–2009 are annual averages of interest rates on loans to companies of up to EUR 1m with a maturity of up to one year, which are deflated with the average annual inflation.

in the public sector combined with new hiring), but there were also changes that reduced revenue (higher general tax breaks implemented with new income-tax legislation and a lower corporate income tax rate). To perform a stabilising role, fiscal policy should have combined tax cuts and higher tax breaks in good (economic) times – when realised revenues were higher than planned – with a more robust curbing and restructuring of expenditure. In assessing the fiscal position in 2008, however, it is necessary to take into consideration that the economic crisis erupted towards the end of the year, undermining public finances but not yet having an impact on the output gap. The calculated fiscal position in 2008 does not take account of the fact that the revenue shortfall was caused by a slowdown in economic activity, which already amounts to counter-cyclical action. In 2009, when economic activity plunged and the output gap widened, the increase in the cyclically adjusted deficit, mainly a consequence of stimulus measures (expansionary fiscal policy), acted counter-cyclically. Estimates based on the state of public finances forecast in the Stability Programme – Update 2009 show that the cyclically adjusted deficit will increase marginally this year, so fiscal policy will remain counter-cyclical in the face of a still very high negative output gap.

**After Slovenia joined the EMU, the combination of monetary and fiscal policy was not co-ordinated and counter-cyclical.** This is the result, on the one hand, of monetary policy decision-making at euro-

area level, where the situation may differ from that in an individual country, and on the other hand of a cyclical fiscal policy (until 2009) and fiscal restrictions that do not always allow for major fiscal-policy adjustments (in 2009). The orientation of monetary policy is estimated by considering the changes in real short-term interest rates. Until 2007, the Bank of Slovenia had an independent monetary policy, but when Slovenia joined the EMU, the ECB rate<sup>10</sup> became the key instrument of monetary policy. In the period 2004–2008, monetary and fiscal policies were not always co-ordinated. In 2004, when the output gap was negative, the restrictive fiscal policy was pro-cyclical given the expansionary monetary policy. This was also the case in 2006, when fiscal policy was expansionary and monetary policy restrictive. In 2007, fiscal policy was mildly expansionary and, given the positive output gap, cyclical. At the same time, real interest rates in Slovenia were low compared to the euro-area average due to the relatively high inflation, which made monetary policy expansionary. Bearing in mind that common monetary-policy measures at euro-area level have a crucial impact on interest-rate changes, achieving an appropriate combination of macroeconomic policies at the national level requires a more flexible fiscal policy. The output gap was positive in 2007, hence fiscal policy should have been fairly restrictive rather than mildly expansionary for the combination of both policies to be more counter-cyclical. In the second half of 2008, real interest rates started to drop along with the deterioration of economic conditions and fiscal policy became more expansionary. In 2009, when inflation was low, real interest rates in Slovenia rose in relative terms despite the ECB cutting its benchmark rate from 2% to 1% in mid-May 2009, which had a cyclical impact given the negative output gap. Considering the high deficit, scope for making fiscal policy more expansionary was limited; fiscal policy was at the limit of restrictiveness and, against the backdrop of a strong contraction in economic activity, it was practically neutral.

<sup>10</sup> Key nominal interest rates in Slovenia (e.g. rates for corporate lending) followed the changes in the ECB benchmark rate, but because inflation was high, real interest rates were relatively low from the end of 2007 to mid-2008.

### 3. Financial flows between Slovenia and the EU budget

**After being a net contributor to the EU budget in 2007 and 2008, Slovenia was a net recipient of EU funds in 2009 in the amount of EUR 155.7 m, according to data from the Ministry of Finance.** In general, the absorption of EU funds is not equally distributed throughout the year or year-on-year within one financial perspective, but depends on the quality of proposed projects, as well as the preparation and implementation of tenders; all this affects absorption capacity, which may therefore vary through the years. After two years of relatively modest drawing of EU funds, in 2009, 73% of the planned total of funds were drawn, which is already comparable to 2006, the most successful year to date, when Slovenia absorbed 77% of the planned funds. Last year's improvement was also due to measures taken at EU and national level. At the EU level, a measure to speed up allocation of EUR 6.3 bn from social and regional policy funds to Member States was adopted as part of the EERP. At the national level, measures focusing on improving Slovenia's administrative absorption capacity<sup>11</sup> were taken to improve the drawing of cohesion-policy funds (February 2009). EC data<sup>12</sup> for 2009 on all financial flows between Slovenia and the EU are not yet available. It is expected that the net position will be significantly better according to EC data than according to the data of the Ministry of Finance (EC data typically show higher EU-budget receipts, while differences on payments to the EU budget are insignificant).

**Drawing of funds from the EU budget improved across all segments in 2009, most notably in cohesion policy and structural reforms.** Much as

<sup>11</sup> Measures include: (i) the possibility of transferring drawing rights for earmarked EU funds and own funds between budget users; (ii) changes and amendments to regulations and instructions on advances from the state budget with consideration of the possibility of defining VAT as an eligible cost and use of flat-rate payments; consideration of the possibility of certifying costs from integral items in the 2007 and 2008 budgets that are classified under the activities of the reformed Lisbon Strategy and/or meet cohesion policy goals, with a view to increasing revenue from the EU budget.

<sup>12</sup> Ministry of Finance data do not include all funds that Slovenia receives from the EU budget, but only funds channelled through the state budget. EC data include refunds to the state budget, as well as funds refunded directly to final beneficiaries in a budget year. According to Ministry of Finance data, Slovenia had a negative net position to the EU budget of EUR 64.7 m in 2008, whereas EC data suggest a positive net position of EUR 113.8 m.

Table 6: Net position of the Republic of Slovenia with respect to the EU budget, 2004–2008

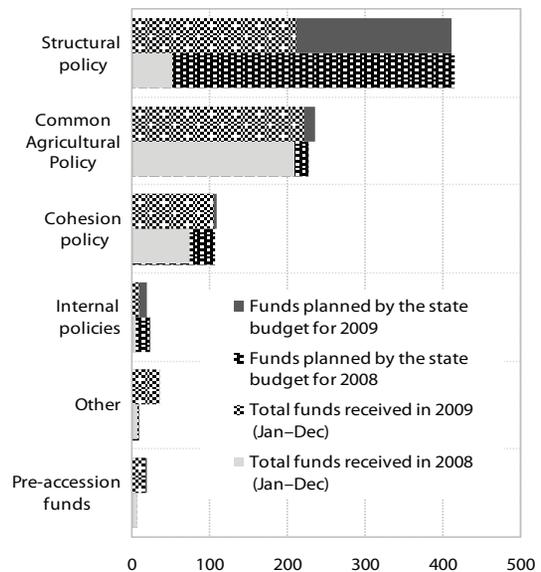
	In EUR m				
	2004	2005	2006	2007	2008
Total funds received from the EU budget	282.0	366.2	406.1	390.1	456.4
Total funds paid to the EU budget	170.4	274.7	279.1	359.4	408.5
Net position – accounting definition*	111.6	91.5	126.9	30.7	47.9
Net position** - (operating budgetary balance)	109.7	101.5	142.7	88.5	113.8

Source: EU Budget 2008 Financial Report.

Notes: \* Net position based on the accounting definition is calculated as the difference between total receipts and total payments.

\*\* Net position is calculated as the difference between allocated and contributed funds, excluding administrative expenditure, and taking into account adjusted national contributions based on the UK rebate.

Figure 8: Planned and allocated funds from EU budget



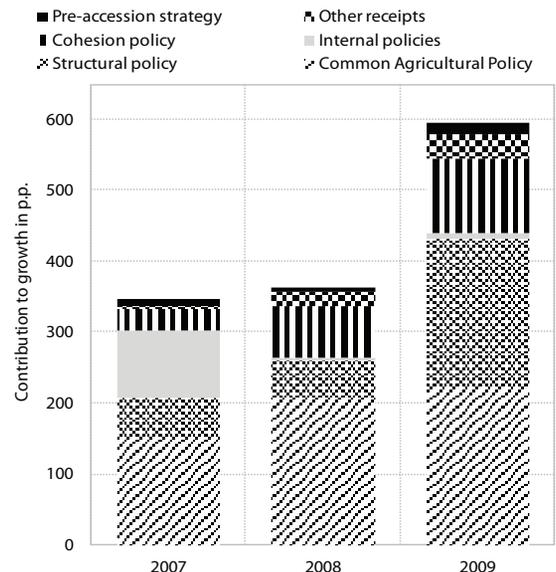
Source: Ministry of Finance.

in previous years, Slovenia absorbed almost all of the planned Common Agricultural Policy funds. In cohesion policy, the situation improved substantially over the previous year as 97% of planned funds were realised, the best rate to date. About 90% of the funds under the Operational Programme of Environmental and Transport Infrastructure Development within the new financial perspective were drawn, and Slovenia also received some funding from the environment and transport programmes of the previous financial perspective. Structural funds were at just over 50% of plans, more than in the 2004–2008 period (average: 30.1%) and nominally the highest to date. Most of the funding came from the Regional Development Fund and a smaller proportion from the European Social Fund. Funds from pre-accession programmes (82.9%) and internal policies (41.7%) fell short of the levels planned, but the minor share of these funds in

the total planned funding means their impact on the overall success of absorption is negligible. Slovenia also received some refunds<sup>13</sup> from the EU budget, representing a surplus of payments to the EU budget in previous years as a result of higher estimates of payments based on the subsequently determined size of statistical aggregates. On the expenditure side, Slovenia almost fully (97.2%) realised planned payments to the EU budget. GDP-based expenditure was higher than planned and other payments were marginally below plans.

**Data on allocated and drawn structural and cohesion policy funds, which account for a substantial share of the funding that Slovenia receives from the EU budget,<sup>14</sup> show that Slovenia is successful in drawing funds under the old financial perspective, whereas absorption of funds under the new financial perspective improved last year after two years of relatively modest inflows.** Eligibility for structural-policy funds from the old financial perspective ended at the end of June 2009 and eligibility for cohesion-policy funds expires at the end of 2010. Between 2004 and 2009, Slovenia absorbed 109% (EUR 258.0 m) of all planned structural funds. Most of the co-funded projects have been completed and the final refund requests to the paying authority are being prepared. Due to European Commission rules stipulating that programmes must be concluded before refunds are made, over 95% of the funds cannot yet be refunded. The difference can be refunded after final controls have been carried out, by October 2010 at the latest. Cohesion-policy funds from the old financial perspective (ISPA and Cohesion Fund) have been almost fully allocated. A total of 88.4% of transport

Figure 9: Structure of funds allocated from EU budget to state budget



Source: Ministry of Finance.

funds and 70.8% of environment funds were refunded from the EU budget at the end of 2009. In 2009, drawing of funds from the new financial perspective improved (from 0% and 1.2% in 2007 and 2008 respectively to 13.2% in 2009<sup>15</sup>), which was increasingly followed by refunds to the state budget. SVLR (GOSP) data show that use of all planned funds was certified for eligibility in 2007–2007, while refunds still lag behind signed contracts. In 2009, progress was made over the previous year in confirmation of operations, as well as refunds from the budget and submitted requests for payment. Despite major delays in refunds from the EU

Table 7: Drawing of cohesion policy funds from 2007–2013 financial perspective (as at 31 December 2009)

		In EUR m				% with regard to eligibility 2007–2009			
		OP ETID*	OP SRDP*	OP HRD*	Total all OPs*	OP ETID*	OP SRDP*	OP HRD*	Total all OPs*
Eligibility 2007–2009	EU part	434.0	869.7	362.0	1,665.7				
	SI part	76.6	153.5	63.9	294.0				
	Total	510.6	1,023.2	425.9	1,959.7				
Confirmed operations	EU part	429.9	991.1	352.7	1,773.7	99.1	114.0	97.4	106.5
Signed contracts	EU part	271.1	818.7	348.4	1,438.1	62.5	94.1	96.2	86.3
Executed payments	EU part	133.7	458.8	76.7	669.2	30.8	52.8	21.2	40.2
Submitted expense claims		106.6	383.7	49.4	539.7	24.6	44.1	13.5	32.4
Certified expense claims		106.4	78.8	3.2	188.4	24.5	9.1	0.9	11.3

Source: Government Office for Local Self-Government and Regional Policy (GOSP); calculations by IMAD.

Note: \* OP ETID – Operational Programme of Environmental and Transport Infrastructure Development, OP SRDP Operational Programme for Strengthening Regional Development Potentials, OP HRD Operational Programme for Human Resource Development.

<sup>13</sup> At the request of the Court of Audit in 2008, the Ministry of Finance now records budget revenue and expenditure in full (gross) sums. Even though Slovenia transfers less funds to the EU budget in the month that a refund is made, the sum is recorded as expenditure under payments to the EU budget and revenue from the EU budget.

<sup>14</sup> Data differ from data by the Ministry of Finance, which monitors all funds received from the EU budget to the state budget on the revenue side.

<sup>15</sup> With regard to eligibility 2007–2013.

budget in early 2009, by the end of the year, requests for refunds increased substantially, which started to be reflected in acceleration of the certification of realised expenses. These refunds are classified as budget revenue and hence improve the net position to the EU budget. Despite good progress in 2009, however, there are still significant delays in refunds to the state budget, especially in the Operational Programme for Human Resources Development and, to a lesser extent, in the Operational Programme for Strengthening Regional Development Potentials.

***Drawing of EU funds will be a vital element in the consolidation of public finances in the coming years according to the Stability Programme. Failure to realise objectives in this area would pose a significant risk to the success of deficit reduction; it could have an adverse impact on the dynamics of investment activity and hence the speed of economic recovery.***

The adopted budget projects that Slovenia will be a net recipient of EU funds at the end of the year. The planned inflow of EU funds amounts to EUR 1,154 m, almost double last year's level. In the first four months, 13% of the planned funds were drawn. Although the dynamics of drawing of EU funds is typically slower in the first months of the year, with the bulk of drawing carried out in the final quarter, the low realisation to date suggests that this very ambitious objective will be difficult to achieve. Additional efforts will therefore be needed in the coming months to improve absorption. Due to limited budget revenue, European funds are a key source of revenue, and will be even more so in the coming years than this year. Success in drawing EU funds for financing of investments is an important element of fiscal consolidation under the Stability Programme, and will contribute to economic recovery. Failure to realise the planned scope of drawing of EU funds poses a risk to the projected deficit reduction and a shortfall in the financing of investments could have a negative impact on economic growth.

## 4. General government debt

***General government debt soared in 2009, mainly as a result of a high deficit and additional borrowing by the treasury to finance the deficit in 2010.*** Having been falling for several years in relative terms, general government debt widened from 22.6% of GDP in 2008 to 35.9% of GDP in 2009, or by EUR 4.1 bn (49%). The overall debt rise was largely the result of a 12.5 p.p. increase in debt at general government level, which also accounts for the bulk of total debt (97.4% at the end of 2009). Some of the funds obtained with borrowing were earmarked as coverage of the EUR 1.9 bn general government deficit. The remaining share of the funds, including front-loaded borrowing to finance the deficit in 2010,<sup>16</sup> was channelled to the banking system, in the form of deposits whose maturity was extended during the year, to prop up liquidity.<sup>17</sup> Increased indebtedness of local communities and the social-security funds contributed a combined 0.5 p.p. to last year's increase in general government debt. Debt of local communities, which had been below 1% of GDP for many years, edged up in 2009, but still remained at a relatively low level<sup>18</sup> (1.5% of GDP at the end of 2009). Social-security funds recorded a minimal deficit (EUR 2.5 m).

***Over the recent years, long-term debt securities have accounted for the bulk of government borrowing. Despite tighter borrowing conditions, Slovenia issued three reference bonds on international markets in 2009, in the total amount of EUR 4 bn.*** Debt securities, most of them long-term, accounted for about 90% of overall debt at the end of 2009. Having entered the European financial market,<sup>19</sup> Slovenia has formed an investor base that has allowed it to issue three new reference bonds, one issue worth EUR 1 bn and two worth EUR 1.5 bn each (with average interest of 4.42%), despite difficult conditions on international

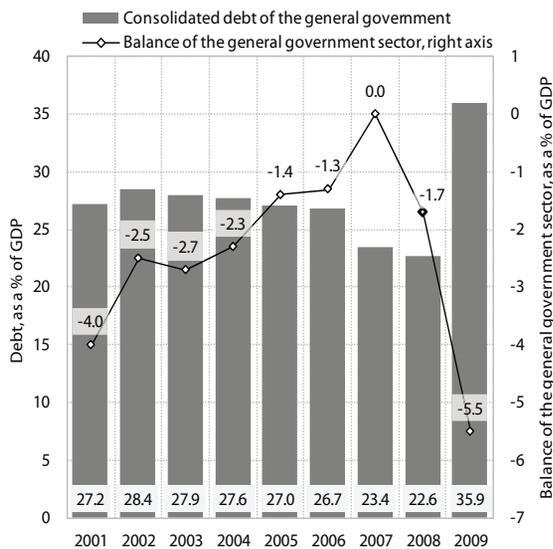
<sup>16</sup> Amendments to the Public Finances Act of 2008 gave the treasury the option of borrowing the equivalent of due principal payments in the next budget year.

<sup>17</sup> A temporary change of conditions for deposits by the Treasury Single Account in commercial banks extended the maximum maturity of treasury deposits to 21 months.

<sup>18</sup> Borrowing by local communities is limited with the Financing of Municipalities Act, which stipulates that a local community's debt may not exceed 20% of last year's revenue and expenditure on debt servicing (interest and principal) may not exceed 5% of the realised revenue from the previous year. This figure can rise to 8% for investment in education, housing, waste treatment, water supply and projects co-financed with EU funds. In these cases, the 20% cap on borrowing is also abrogated.

<sup>19</sup> Slovenia issued the first reference bond, worth EUR 1 bn, in 2007 and the second, also worth EUR 1 bn, in 2008, making a successful debut on the European market of government bonds.

Figure 10: General government debt and deficit, as % of GDP



Source: Basic aggregates of the general government (SORS), General government debt and deficit report (Ministry of Finance and SORS), 2009.

financial markets.<sup>20</sup> The bonds were purchased primarily by previous investors in Slovenian bonds.

**Measured by debt and interest as a share of GDP, Slovenia is still one of the least indebted EU countries, but its relative debt increase was among the highest in the EU last year.** European Commission estimates show Slovenia's debt was well below the euro-area (78.2% of GDP) and EU average (73.6% of GDP) in 2009. Nevertheless, the increase as a share of GDP (13.3 p.p.) was above the average in the euro area (9.3 p.p.) and the EU (12 p.p.). In the euro area, general government debt as a share of GDP rose faster only in

Ireland (20.1 p.p.), Greece (15.9 p.p.) and Spain (13.5 p.p.), and outside the euro area, in Latvia (16.6 p.p.), the United Kingdom (16.1 p.p.) and Lithuania (13.7 p.p.).

**During the crisis Slovenia managed to maintain its rating whereas the yield to maturity of government bonds was significantly lower than in high-risk countries.** Bond yield is a key indicator showing the credit and liquidity risk that financial markets attribute to a country. The yield curve is affected by macroeconomic trends, as well as one-off and external factors which can affect how financial markets perceive a country's standing, in particular during an economic crisis (the contagion effect). Since the outbreak of the financial and economic crisis, Slovenia has managed to retain its rating (AA+/Stable/A-1)<sup>21</sup> and the trajectory of borrowing conditions has not been significantly different from those of other key financial-market players, mainly due to relatively low deficits in the past and low public debt. A comparison of yields of 10-year government bonds of selected euro-area countries shows that Slovenia was among the countries with an above-average yield last year, but the spread on Germany's bonds followed a similar trajectory to bonds of other euro-area countries and was substantially lower than in high-risk countries. After hovering at a relatively high level between November 2008 and July 2009, yield to maturity dropped close to pre-crisis levels in the second half of the year.

**Rating agencies have lately been placing greater emphasis on residents' share of holders of government debt, but, given the high degree of financial integration, this is impossible to control.** Financial-market players from euro-area countries

Table 8: Balance of consolidated general government debt by sub-sectors, Slovenia, 2005–2009

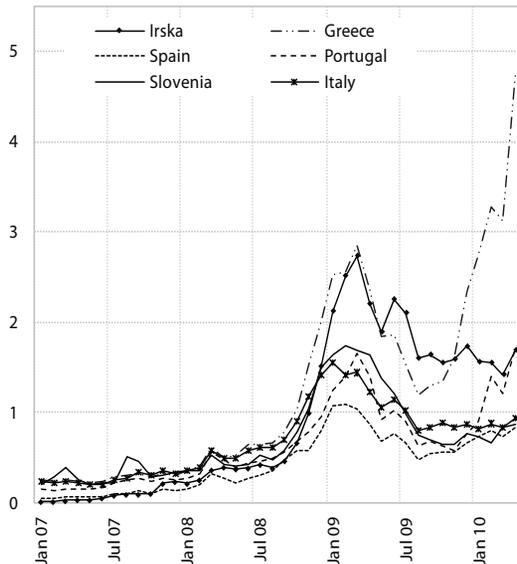
In EUR m		2005	2006	2007	2008	2009
1	Total general government	7,754.7	8,288.7	8,084.9	8,388.8	12,518.9
1.1	Central government	7,653.0	8,208.6	8,008.5	8,299.8	12,182.4
1.2	Local government	210.5	235.7	255.1	353.6	519.6
1.3	Social-security funds	20.3	3.1	2.8	2.7	2.5
1.4	Consolidated debt among sub-sectors	129.1	158.7	181.5	267.3	185.6
As % of GDP						
1	Total general government	27.0	26.7	23.4	22.6	35.9
1.1	Central government	26.7	26.5	23.2	22.4	34.9
1.2	Local government	0.7	0.8	0.7	1.0	1.5
1.3	Social-security funds	0.1	0.0	0.0	0.0	0.0
1.4	Consolidated debt among sub-sectors	0.4	0.5	0.5	0.7	0.5

Source: Main aggregates of the general government (SORS), Report on general government debt and deficit (Ministry of Finance and SORS), 2010; figures before 2007 converted using the irrevocably fixed exchange rate of 239.64 tolar to the euro.

<sup>20</sup> Government bonds in the euro area had long had similar yields, but the yield spread widened with the onset of the financial crisis.

<sup>21</sup> Rating by Standard & Poor's.

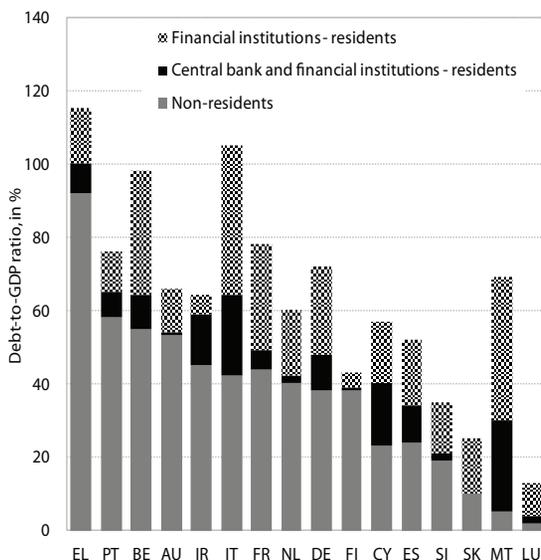
Figure 11: Yield spread of 10-year bonds on the reference bond (Germany)



Source: Eurostat.

face no restrictions on monetary, interbank and government bond markets, where the degree of financial integration was highest according to a 2008 estimate by the EC (European Financial Integration Report, EC, 2008). Until the escalation of the financial and economic crisis, this was demonstrated in the relatively low spread of euro-area government bonds relative to the German reference bond and an increasing share of cross-border (non-resident) holders of government debt. Between 2001 and 2008, the average share of non-resident bond

Figure 12: Euro area general government debt by debt holders (2009, as % of GDP)



Source: ECB Financial stability review 2010.

holders in the euro area rose from 22% to 40%, but as the crisis escalated it dropped to just over 30%. Considering the high degree of financial integration, the share of residents among a country's debt holders is impossible to control, as the structure of holders depends primarily on the depth of the financial market. Moreover, in small economies, a high proportion for residents would crowd out other investments. The share of residents and non-residents among debt holders can affect debt-servicing costs if debt and interest are high, as a portion of the interest paid to residents is funnelled back to the budget as taxes. A higher share of residents has recently been highlighted by rating agencies as a factor that may reduce the risk of debt default and limit cross-border spillover effects, which affect the financial stability of institutions in other countries. Italy is a case in point: having a relatively high share of residents among debt holders, it has a better rating and lower spread on German bonds than countries in a similar fiscal position, despite having the second highest debt-to-GDP ratio in the EU.

**Consolidation of public finances is key to preserving a stable rating, but a deepening of the domestic financial market would also have a positive impact.**

ECB data show that Slovenia is placed in the middle of EMU countries by share of non-resident holders of government debt in 2009. With a relatively shallow financial market and high degree of financial integration, it had been expected that the share of non-residents among holders of government debt would increase following Slovenia's adoption of the euro. Given the current debt level and servicing liabilities, the present structure of government debt holders does not pose a higher risk to Slovenia's ability to service its debt. To retain its rating and preclude a worsening of Slovenia's standing on financial markets, it is vital that fiscal policy ensures borrowing conditions remain at the present level by consistently consolidating public finances and thereby preserving the present borrowing conditions (indicated by the spread on German bonds). This will allow Slovenia to reign in servicing costs and the crowding out of other government expenditure, and contribute to preservation of borrowing conditions for private-sector players on the financial market, which are largely dependent on the yield of government bonds.<sup>22</sup> Deepening of the domestic financial market, by measures including the development of the second and third pension pillars, would help to increase the share of residents, and this would have a favourable impact on the rating.

<sup>22</sup> Analysis of yield to maturity of government bonds and its impact on the borrowing conditions of the entire economy will be presented in-depth in a forthcoming IMAD working paper.

**Given that expenditure associated with the ageing of the population will grow at an accelerated rate in the coming years, the current pace of debt expansion and the scope of implicit liabilities increase the mid- and long-term risk to the stability of the public finances.** This lends growing urgency to ensuring the sustainability of public finances, which will require a restructuring of expenditure and revenue, and a modernisation of social-protection systems. Moreover, in addition to fiscal-policy measures directly increasing deficit and debt, measures including public guarantees that strongly increase potential liabilities in the coming years have been taken in an effort to cushion the impact of the economic and financial crisis. To tackle the financial crisis and facilitate a normal flow of credit to businesses, the government provided two domestic banks with guarantees<sup>23</sup> in the amount of EUR 2 bn, while commercial banks were granted risk-sharing guarantees for financing of the real sector and crediting of households (banks have so far used EUR 184 m of the allocated EUR 459 m quota). The balance of guarantees, excluding guarantees issued as part of efforts to overcome the credit crunch, increased in 2009 by EUR 252 m, most of which was provided to companies in transport, finance and insurance industries. Even though state guarantees do not directly increase general government debt until they are called up, their very scope and the estimate of probability of being called up can affect the way a country is perceived by financial markets, and this can make borrowing more expensive by widening spreads.

## 5. Long-term sustainability of public finances<sup>24</sup>

**The financial and economic crisis highlighted the sensitivity of fiscal and other macroeconomic balances.** Owing to the complexity of the economic system, even relatively insignificant causes can disturb macroeconomic balances, while larger shocks such as the financial and economic crisis can cause major difficulties. Governments must therefore control expenditure, revenue, inflation and debt levels at all times, and remain mindful of long-term prospects. In normative terms, this complexity and the parameters of balance are determined by the EC Treaty, and in economic policy by the Growth and Stability Pact, which includes parameters of the long-term sustainability of public finances.

**In the long term, Slovenia's fiscal position crucially depends on projected demographic changes, which indicate a very unfavourable trend if social-protection systems are left intact.** Population projections made in 2008<sup>25</sup> confirmed that populations in all EU countries, and Slovenia in particular, are ageing quickly. As a result, by virtue of the altered age structure alone, there will be increasing demand for pensions, health and social care. In fiscal terms, this means that implicit government liabilities are growing. Given the concurrent drop in the share of the working-age population, it is unrealistic to expect sufficient funding from contributions to cover rising expenditure, i.e. to finance implicit expenditure with explicit revenue. With the given (predictable) revenue, unmet future government liabilities are a bigger bubble, and a more difficult problem to resolve, than the financial bubbles that triggered the present crisis. A fiscal effort to ensure long-term sustainability of public financing would have to increase the primary fiscal balance by 6.2 p.p. of GDP by 2060 (indicator S1), provided there is no change of policy and social-protection systems; to achieve intertemporally balanced public finances (indicator S2) the primary balance would have to be 10.5 p.p. of GDP<sup>26</sup> higher.

<sup>24</sup> Projections of revenue associated with population ageing are taken from Reports on projections of public expenditure that is a consequence of population ageing, with results of projections, IMAD, documents for the Government, 12 January 2009. The differences occurred in the projections of expenditure on health care and long-term care, where the European Commission's methodology is slightly different than that used in Slovenia.

<sup>25</sup> Eurostat: Population Projections EUROPOP2008.

<sup>26</sup> The S1 and S2 coefficients are estimated based on the model of generational accounts. They measure the size of the permanent budget adjustment ensuring that (i) public debt remains at 60% of GDP in 2060 (indicator S1) and (ii) the intertemporal budget

<sup>23</sup> Based on Article 86.a of the Public Finance Act.

Table 9: Decomposition (in % of GDP) of public expenditure on pensions between 2007 and 2060 in projection from 2008

Change in total public expenditure on pensions 2007–2050, in p.p.	Change of			
	Age dependency ratio	Coverage ratio	Employment rate	Benefit ratio
8.5	10.2	-0.5*	-0.2	-2.0

Source: Report on projections of public expenditure that is a consequence of population ageing, with results of projections, IMAD 2009.

Note: \* The retirement rate (ratio between the number of pensioners and the population over 55) reduces the projected increase in pension expenditure due to population ageing by 0.45 p.p. (5%).

### Pensions account for the bulk of expenditure related to population ageing.

Long-term projections of pension expenditure from 2008<sup>27</sup> show that its share in GDP will increase by 8.5 p.p. by 2060 in the absence of policy changes. The main reason for increased public expenditure on pensions is the rising share of the elderly. The effects of this projected increase are reduced<sup>28</sup> by the coverage ratio, employment rate and benefit ratio. Expenditure projections assume that the retirement age will rise. The number of pensioners presently exceeds the size of the population over 65. Since the number of pensioners under the age of 65 will drop in the future, the dependency ratio will fall from the present level towards one. This change somewhat mitigates the intensity of the increase of projected pension expenditure, which is underpinned by demographic changes and is denoted as population ageing. The impact of ageing on pension expenditure will also be reduced with a lower benefit ratio (approximately corresponding to a reduced replacement rate), i.e. with a considerable drop in the relative value of pensions from the public pension system compared with wages, and a higher employment rate. The combined projection of public expenditure on pensions, health care and long-term care as a share of GDP (see Table 8) clearly shows the potentially biggest increases in public expenditure and hence the biggest sources of risk to public finances.

### The effects of the financial and economic crisis, which are not included in the projections, will further undermine the long-term sustainability of public finances.

In the short term, the financial and economic crisis caused a rapid slowdown in economic activity and employment, and slowed wage growth in Slovenia. Over the medium term, it has reduced potential GDP growth, which worsens the ratio between ageing-related expenditure and funding for its financing, and increases its share in GDP. The long-term sustainability of public finances is thus becoming even more problematic and subject to numerous risks, in particular since the crisis has highlighted the fact that large economic shocks can happen and can seriously undermine the achieved ratios. In 2008 and 2009, public expenditure on health care and pensions as a share of GDP rose due to the slowdown and the subsequent contraction of GDP – the former from 5.6% in 2007 to 5.8% in 2008 and 6.7% in 2009, and the latter from 9.7% to 9.9% and finally to 11.1% of GDP. The present level of public expenditure on ageing-related public functions is at a level that according to baseline scenarios would have been achieved around 2015, which means that public finances would become unsustainable earlier than projected.

### Considering the high level of ageing-related public expenditure, systemic changes in the provision of pensions and health care will be required. The

Table 10: Projection of public expenditure on pensions, health care and long-term care, as % of GDP

	2007	2020	2030	2040	2050	2060	Peak year
Social-security pensions	9.85	11.09	13.27	16.12	18.19	18.62	2060
Health care	6.1	6.8	7.8	8.8	9.6	9.9	2060
Long-term care	1.0	1.4	1.8	2.4	2.9	3.2	2060

Source: Report on projections of public expenditure that is a consequence of population ageing, with results of projections, IMAD 2009.

constraint is observed, i.e. that debt remains unchanged over an unlimited time horizon (indicator S2). The indicators are subject to similar criticism as overall simulations of demographic change, so they are used in the analysis only as indicators that quantify changes that would occur if the economic environment and policies remained unchanged.

<sup>27</sup> Since the projection from 2008 was extended to 2060, it makes sense to compare the two only for the period until 2050.

<sup>28</sup> The results of the projections are affected by many factors, in particular (1) age-dependency ratio, (2) coverage ratio, (3) employment rate and (4) benefit ratio.

$$\frac{\text{Pension expenditure}}{\text{GDP}} = \frac{\overbrace{\text{Population } 55+}^{\text{Dependency ratio}}}{\text{Population } 15-64} \times \frac{\overbrace{\text{Number of pensioners}}^{\text{Coverage ratio}}}{\text{Population } 55+} \times \frac{\overbrace{\text{Population } 15-64}^{1/\text{Employment rate}}}{\text{Working people}} \times \frac{\overbrace{\text{Average pension}}^{\text{Benefit ratio}}}{\text{Working people}} \times \frac{\text{GDP}}{\text{Working people}}$$

first reaction to the significant deterioration in the coverage of liabilities of social-protection systems was to limit expenditure by changing the rules for benefits in kind (prices of health services) and cash (pensions, in particular). The change of rules under the Emergency Measures due to Economic Crisis Act<sup>29</sup> applies in 2010. In health care, this meant an increase in out-of-pocket copayments for compulsory public services. In pensions, the valorisation rule was changed for 2010 to halve the adjustment of pensions over what is stipulated in the Pension and Disability Insurance Act.<sup>30</sup>

***Long-term sustainability of public finances will crucially depend on systemic adjustments of social-protection systems and on economic-policy measures that will raise potential output.***

Considering the projected (expected) future level of ageing-related public expenditure, the provision of pensions and health care will be subject to systemic changes on top of those already envisaged in the Exit Strategy. Changes have been geared towards prolonging activity and postponing retirement, but there is less readiness for implementation of more diversified entitlements. Universal entitlements and the high level thereof require a great deal of redistribution, which can be carried out only with substantial public funds. Expectations are being created and demands made that the lack of public funding can be solved by increasing mandatory social-security contributions. But to ensure the long-term sustainability of provision of pensions, health care and long-term care, new combinations in public financing<sup>31</sup> are needed and the entitlements financially covered by social insurance will have to be more closely tied to contributions. In meeting these needs, it will be necessary to allow and enable a greater role for private decisions and private funds. But, to cover expenditure in the period between 2025 and 2040, when problems in public funding will be most acute for demographic reasons, assets earmarked for this purpose need to be retained and increased now. This role is currently performed by KAD (Kapitalska družba – Pension Fund Management), but, at least in the long term, its assets should not be used to cover the current deficit of the Pension and Disability Insurance Institute. If politicians and social partners fail to reach agreement, the fiscal position will soon force additional changes which will be less considered and more painful than those that should be adopted

immediately. The experiences of many countries in such a scenario are very clear. To ensure long-term sustainability of public finances, and thus to reduce the need for borrowing, immediate adoption and implementation of structural adjustments in social protection will have to be coupled with structural changes in other areas to improve competitiveness and raise potential economic-growth rates.

<sup>29</sup> Official Gazette of the RS, No. 98/2009.

<sup>30</sup> In 2010, pensions will be adjusted by half the increase in average wage (for details, see Article 4 of the Emergency Measures due to the Economic Crisis Act).

<sup>31</sup> One possibility, used by Scandinavian countries, is to finance a greater share of liabilities (entitlements) in social systems using general taxes.

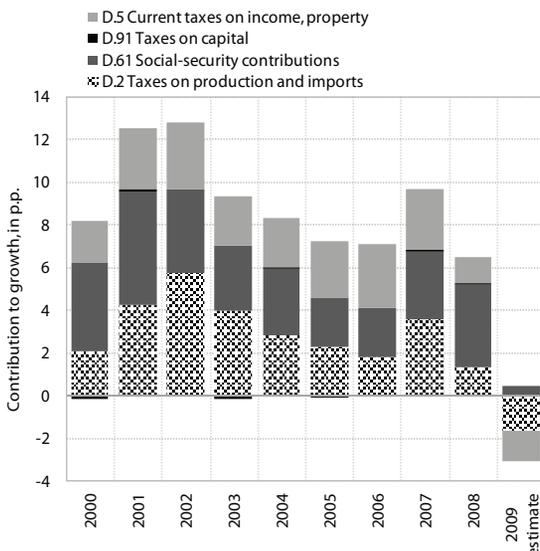
## Part II

### 6. Government revenue: analysis of structure and scope for restructuring

Government revenue comprises taxes, contributions and non-tax revenue (income on property and other income<sup>32</sup>). The total share of taxes and contributions in government revenue has been stable at around 88%. The structure of revenue is crucially determined by the structure of tax burdens; the burden of taxes and contributions is analysed in detail below.

**The total burden of taxes and contributions in Slovenia has been between 37.5% and 39% of GDP throughout the last ten years.** After 2000, the burden of taxes and contributions as a share of GDP was increasing gradually, but after 2005 it started to fall, first in 2006 with the first interventions in tax legislation and more rapidly in 2007 with the implementation of a broader reform of the tax system, which disburdened the economy and the population with a view to improving competitiveness and

Figure 13: Contribution to growth of revenue from taxes and contributions, in p.p.



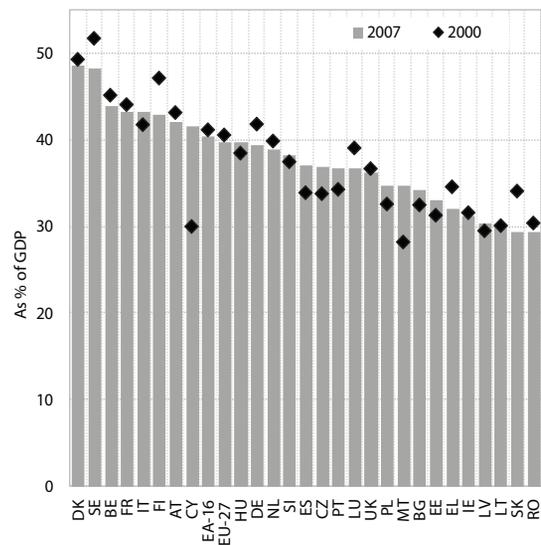
Source: SORS, National accounts, Burden of taxes and social contributions, IMAD estimate.

<sup>32</sup> Income from property, production for market, own final consumption and other non-market production, and other current and capital transfers.

creating a stimulating tax environment conducive to economic growth. In 2009, the burden again rose as GDP dropped more quickly than total taxes and contributions. Broken down by the main categories of taxes and contributions, social-security contributions were the most consistent driving force behind the rise in the burden of taxes and contributions in the period 2002–2009, as were, until 2007, taxes on production, income and property. After 2007, the contribution of taxes halved but the contribution of social-security contributions increased in relative terms.

**Slovenia's total burden of taxes and contributions is slightly below the EU average, but broken down by economic structure,<sup>33</sup> the share of taxes on labour and consumption is above average and the share of taxes on capital in the total burden below average.** In 2007,<sup>34</sup> the total burden stood at 38.2% of GDP in Slovenia and averaged 39.8% of GDP in the EU and 40.4% in the euro area, according to comparable data. There are significant differences between the Member States, with the gap between the highest and the lowest burden over 19 p.p. of GDP in 2007. The economic structure of taxes also varies depending on tax systems in Member States. In the EU on average, the share of taxes on labour (45.2%) was substantially lower than in Slovenia (51.4%), whereas in the euro area it averaged 44.7%. The share of taxes on consumption was also slightly

Figure 14: Burden of taxes and social-security contributions, as % of GDP



Source: Eurostat, Taxation trends in the European Union, 2009.

<sup>33</sup> The division of taxes into three economic categories is based on the tax classification in the methodology of the system of national accounts.

<sup>34</sup> 2007 is the last year for which comparable data for EU Member States are available.

lower than in Slovenia (Slovenia: 34.7%, EU-27: 33.6%, EMU: 31.5%), but the share of taxes on capital was substantially higher (Slovenia: 13.8%, EU: 21.3%, EMU: 23.9%).

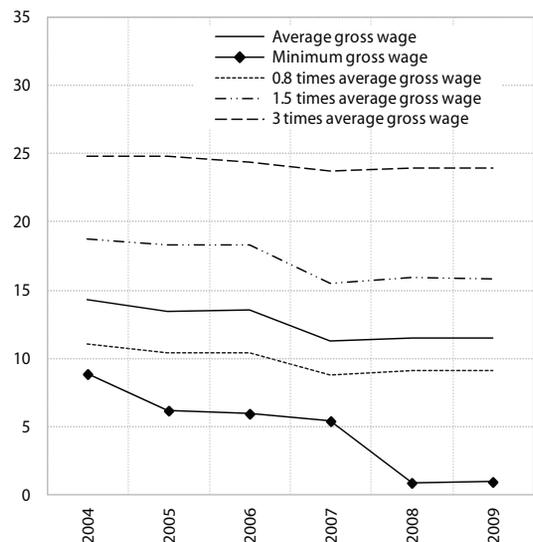
## 6.1. Taxes on labour

**The share of taxes on labour dropped over the past year, but remains high.** Taxes on labour as a share of total taxes and contributions reached almost 54% in 2000, whereupon this share started to fall, most notably after 2006, when it decreased to 50% in 2007 due to the gradual abolition of the payroll tax. In 2008 and 2009, it inched up again as wage growth swelled social-security contributions, and income-tax revenue rose as a result of a tax reform. In 2010 (taking into account the supplementary budget), our estimate indicates that it will drop slightly (to 50%) due to the projected drop in the wage bill.

**Employees' and employers' social-security contributions<sup>35</sup> account for the bulk of taxes on labour.** They represent over 70% of taxes on labour, with income tax accounting for just over a quarter of the total burden and the rest spread among other taxes on labour. With unchanged contribution rates (38.2% of the wage bill since 2002), revenue from social-security contributions has followed the trajectory of the wage bill and represents one of the most stable sources of revenue. Social-security contributions hovered around 14.5% of GDP between 2000 and 2008, except in 2007, when their share was lower due to high GDP growth. As economic growth has slowed and the macroeconomic environment deteriorated, non-payment, avoidance and deferral of payment of social-security contributions have become more widespread. Non-payment of contributions reduces the revenue of the pension and health funds and makes it difficult for insured persons to exercise their rights. According to the law, rates of social-security contributions vary depending on taxpayer status and contribution bases, which puts certain groups of taxpayers in a privileged position. Tax benefits allow them to pay contributions not based on economic power but on acquired tax-favourable status, but, at the same time, the system gives them the same social-protection rights. Following the introduction of a dual income-tax system, another way that taxpayers can avoid social-security contributions is by paying out low (including minimum) wages and the rest in the form of more lightly taxed

capital gains. In a system with built-in solidarity, the base for social-security contributions is unlimited, while pension-insurance rights are capped with a maximum pension. Taxpayers with high wages therefore contribute much more to the pension fund than other insured persons, and their contributions exceed the rights they are eligible for under the system. By introducing a cap on the contributions base, this imbalance could be redressed; in the long term, this measure would have a positive impact on economic activity and, consequently, increase revenue. In the short term, however, capping social-security contributions would reduce revenue, which would not be sustainable. The resulting revenue shortfall would therefore have to be offset with other sources. Proposed possibilities for covering the shortfall in the pension and health funds include: expanding the contributions base and at the same time eliminating the inconsistencies of the present contributions system; introducing an additional income-tax bracket; and raising the proportional tax on capital gains (Institute for Economic Research, 2010).

Figure 15: Share of personal income tax in gross wages



Source: Stability Programme – 2009 Update.

**Phase-out of the payroll tax and reform of the income-tax system were the biggest factors behind the disburdening of labour.** The average burden of payroll tax<sup>36</sup> on gross wages dropped by 5.1% of the wage bill between 2005, when it was highest, and 2009, while its share of GDP decreased by 1.8 p.p. Since income taxation is progressive, abolition of the

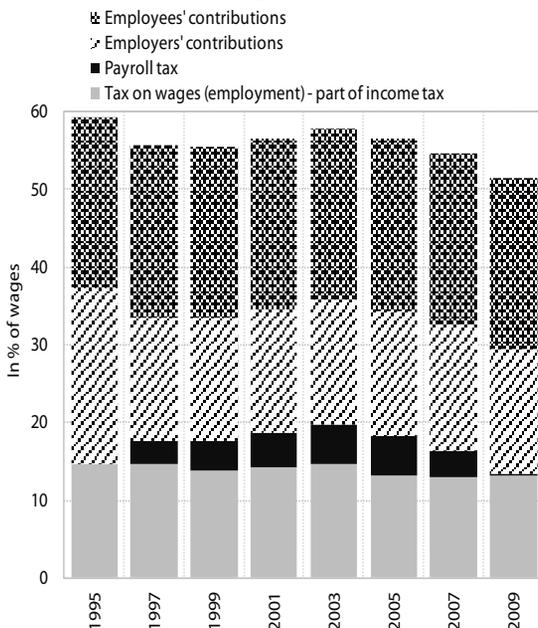
<sup>35</sup> Contributions are paid for pension and disability insurance, compulsory health insurance, employment and maternity leave.

<sup>36</sup> Payroll tax was introduced in the second half of 1996 to disburden the lowest wages of social-security contributions and to provide a source for financing the deficit that had occurred in the pension fund as a result of this burden.

payroll tax disburdened high wages most. Changes to the Personal Income Tax Act in 2006–2009<sup>37</sup> reduced tax receipts: in 2007 alone, when the change was biggest, income tax as a share of GDP dropped by 0.6 p.p. Changes to tax brackets, tax breaks and a reduction of the top rate (from 50% to 41%) disburdened the majority of taxpayers; those in the lowest tax brackets were substantially disburdened, but the largest beneficiaries were those in the top bracket. The introduction of a dual system, in which capital gains are taxed with a lower single rate and exempt from progressive taxation, meant that disburdening was even greater for taxpayers who reported capital gains. Under existing law, income-tax brackets are adjusted to inflation; wages have grown in real terms in recent years which, given the relatively high threshold for the top income-tax bracket, increased the burden on taxpayers in the middle bracket. In 2008, additional tax relief was introduced to further decrease the share of income tax in minimum wages (Figure 15).

**Due to changes in personal income-tax legislation and the payroll tax, the burden on wages of taxes and contributions decreased.** With unchanged rates of social-security contributions (38.2% of wages), the

Figure 16: Average burdening of labour with taxes and contributions, in % of wages



Source: PPA, form B–2, calculations by IMAD.

<sup>37</sup>In 2006, a dual income-tax system was introduced, and in 2007 the Personal Income Tax Act was reformed with an overhaul of the tax brackets and a reduction of the top rate. In 2008 and 2009, tax relief for the lowest tax brackets was increased with the introduction of a two-step additional general tax relief and special tax breaks for investments.

total burden of contributions and taxes on wages has been progressively declining in recent years due to changes in income-tax legislation and the phase-out of the payroll tax. It dropped from 56.6% of wages in 2005 to 51.6% in 2009.

## 6.2. Taxes on consumption

**The share of taxes on consumption in the economic structure of taxes has been quite stable in the last ten-year period.** Value-added tax (VAT) and excise duties account for the bulk of taxes on consumption. Since the introduction of VAT in the second half of 1999, and an increase in the general and reduced VAT rate in 2001, VAT revenue as a share of GDP has accounted for about 8.5% of GDP. Excise policy had, until 2007, been focused on mitigating the impact of fluctuations in global crude oil prices on domestic inflation and a gradual increase of duties on tobacco to levels prescribed by the European directive. However, the increase in excise on energy products in the second half of 2008 and a rise in all other excise duties in 2009, were primarily designed to cushion the decline in budget revenue. The policy of increasing excise rates continues in 2010, but sales of some excisable products (liquid fuels) began to decline. Excise on electricity was introduced in 2007. It is currently very low,<sup>38</sup> but an increase is planned in the supplementary budget. Excise had hovered at around 3.2% of GDP until 2009, when it rose to 4.2%. In 2010, it will have increased to 4.3% of GDP as a result of the increases planned in the supplementary budget.

**In the process of consolidation of public finances, there is still scope to increase taxes on consumption and restructure sources of government revenue towards relatively higher taxation of consumption.** The relatively higher share of taxes on consumption in total taxes is expected, given Slovenia's level of economic development, and is characteristic of countries with below-average per-capita GDP at PPS. We estimate that there is nevertheless scope to increase revenue with VAT by raising the tax rate and expanding catchment. The VAT system achieves the highest degree of simplicity and neutrality when the tax is levied in the most general way possible and when it is used in all phases of production, distribution and rendering of services.<sup>39</sup> There is

<sup>38</sup>This could be raised, but an increase would be very sensitive in social terms as it affects the lowest income brackets most in relative terms.

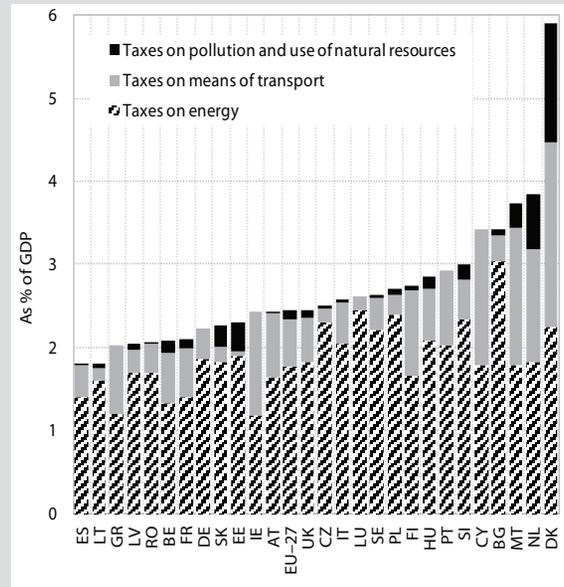
<sup>39</sup>Council Directive 2006/112/EC on the common system of value-added tax – VAT Directive, OG L 374/06 with amendments.

**Box 1: Environmental taxes**

Environmental taxes include levies on the use of energy, means of transport, pollution and use of natural resources. Duties on energy use account for the bulk (over three-quarters) of all government revenue from environmental taxes. Environmental taxes as a share of GDP had been increasing in the EU-15 in particular in the early 1990s, but in new Member States this occurred later and was associated with the process of EU accession. In 2007 (the latest year for which EU data are available), environmental taxes accounted for 2.5% of GDP on average in the EU and 3% of GDP in Slovenia. Compared with other EU countries, environmental taxes in Slovenia are relatively high as a percentage of GDP. Slovenia has relatively high taxes on energy (see Figure 17), pollution and use of natural resources, but lower taxes on means of transport.

Between 2000 and 2004, the share of environmental taxes in Slovenia rose from 3.0% of GDP to 3.3% of GDP. In the next three years, it dropped once more, reaching 2.9% in 2008, the lowest level since 1996. This decrease was primarily a consequence of low taxation of fuels for transportation; before Slovenia joined the EMU, the impact of growing global crude-oil prices on inflation had been mitigated with low taxation of fuels for transportation. In 2009, GDP contracted and taxation of fuels for transportation increased substantially, which, in our view, increased the share of environmental taxes to 3.5% of GDP, the highest since 2000.

**Figure 17: Revenue from environmental taxes, as % of GDP, 2007**



### 6.3. Taxes on capital

**Slovenia has the lowest taxation of capital in the EU in relative terms.** Taxes on capital had accounted for 9.5% of total taxes in 2000, with their share rising to 15.5% in 2007 before it started to fall again to reach around 10% in 2010. Corporate income tax accounts for the biggest proportion of taxes on capital. Affected by cyclical movements and multiple legislative changes, it has been the most important factor determining the structural share of taxes on capital in the total tax burden. In the structure of taxes on capital, it has accounted for from one third to over

half of the total, with the highest level reached in 2007. Until 2006, corporate income tax revenue was rising; the statutory rate was set at 25% and the system of tax relief underwent extensive changes. Revenue from this tax saw the biggest fall after adoption of the 2007 law, when the statutory rate was reduced to 23% amidst high economic growth to relieve the tax burden on the economy, and the rate dropped a further p.p. each year until it reached 20% in 2010. The tax base was redefined and the system of tax breaks<sup>42</sup> altered, which reduced the relative revenue from a peak of 3.4% of GDP to 1.3% of GDP in 2010. Another important part of the tax burden on capital is the

#### Box 2: Real-estate (property) taxes

**The most important property tax in Slovenia in fiscal terms is the tax on the use of building land, but this is too opaque and unfair and should be replaced with a more contemporary real-estate tax.** In international classifications, property taxes are divided into taxes on real estate, net property (this tax does not exist in Slovenia or most other countries), inheritance and gifts, real-estate transactions, capital transactions and other property taxes. In continental EU countries, these taxes are levied almost everywhere, but they play a small fiscal role (smaller than in other developed countries) and Slovenia is at the bottom of the EU ranking in this area. The only such fiscally relevant tax in Slovenia is the tax on the use of building land, which accounts for nearly 0.5% of GDP (about EUR 150 m), or just over 1% of all government revenue. It also accounts for 8% of all municipal revenue, representing the most important source of financing controlled by municipalities. The base of this tax only indirectly and very roughly reflects the generalised market value of real estate, the bedrock of the real-estate tax base in developed countries, so it does not have the potential to become a key pillar of local self-government and development of the real-estate market. Adoption of the Real Property Mass-Appraisal Act and preparations for a real-estate tax are setting the groundwork for replacement of the tax on the use of building land and the present property tax (which is fiscally marginal) with a more contemporary form of real-estate tax.

**The new real-estate tax is not expected to increase tax receipts in the short term or restructure revenue towards a greater share of taxes on capital, but it does play a developmental role and, by extension, a fiscal role in the long term.** The primary reason for the introduction of this tax is to improve local self-government. As elsewhere, quality of local services affects the market value of real estate. Decisions on tax rates at the local level (within the permitted scope) could thus improve decision-making on municipalities' development. At the same time, shifting administration of the tax to the state level would reduce the burden on municipalities and improve transparency and equity of this tax. This would improve the potential for greater reliance on this tax source in the future, provided it is underpinned with cuts in other taxes or improvement in local services. The second group of reasons for introducing a more contemporary form of the tax has to do with development impacts brought about by improved functioning of the real-estate market. Market players would, however, only be motivated to use real estate more rationally if the tax rates were substantial, while motivation to legalise lease relationships (in the event of tax relief for registration of permanent residence) would improve only with lower taxation of leases, the only capital-gains of natural persons in Slovenia that are not yet proportionally taxed. A significant developmental impact may thus only be expected from improved real-estate registers and, consequently, statistics and analyses. This would reduce transaction costs and opportunity losses on the real-estate market, improving transparency and increasing the number of transactions to the levels of more developed countries. This improved allocation function could increase potential economic growth and thus indirectly exert a fiscal impact. The effect on improvement of state records and motivation of public and private owners to sort out the legal deeds on their real estate can already be achieved with minimum tax rates. In fact, this has been the driving force behind the significant improvement of real-estate records in recent years, which was based solely on expectations of the introduction of a new tax.

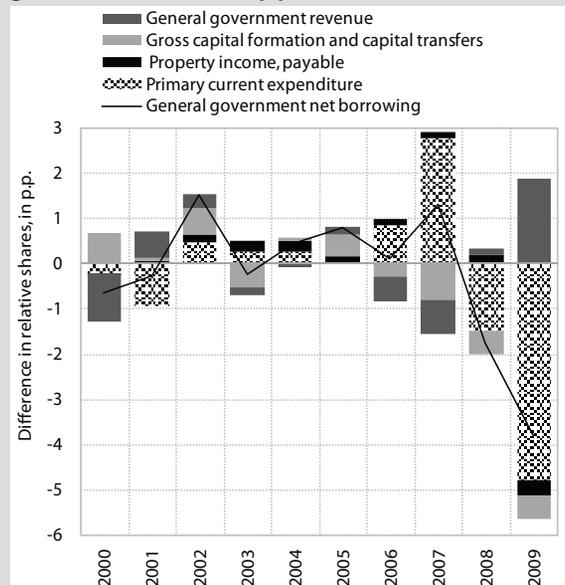
<sup>42</sup> The law abolished a 20% relief on investments in equipment and intangible assets and kept only the 20% relief for investments in in-house R&D, purchase of R&D services, employment of disabled persons and in-company placement in vocational education. Relief was also introduced for voluntary supplementary pension insurance, donations and less developed regions.

**Box 3: Structure of changes in the general government balance in the period 2000–2009**

**The high deficit growth in 2009 is to a large extent the consequence of partial fiscal-policy measures in previous years, when tax cuts were not coupled with systemic restructuring and cutting of government expenditure.**

Between 2001 and 2007, the state of the Slovenian public finances improved each year. The general government deficit gradually dropped from 4% of GDP in 2001 up to 2007, when the government finances were balanced. In 2008, however, the deficit rose by 1.7 p.p. of GDP, and in 2009 by a further 3.8 p.p. During the negotiations for EU membership, fiscal policy focused on reducing the general government deficit to the lowest possible level. This objective was largely achieved, but in certain years fiscal policy was cyclical (see also Section 2.1). Fiscal policy had been limiting government expenditure by restricting wage growth, expenditure on goods and services, and investment activity. In relative terms, primary expenditure therefore dropped between 2002 and 2005, as, with the exception of 2003, did gross capital formation and capital transfers. The debt-management policy meanwhile helped reduce expenditure on interest. At the same time, government revenue was mostly stable, with only customs revenue declining somewhat due to the pre-accession agreement with the EU. In 2006 and 2007, primary current expenditure and interest expenditure continued to fall in relative terms, but investment activity started to accelerate. Favourable economic trends prompted tax-reform measures, which reduced government revenue in relative terms when, in 2006 and 2007, their effects kicked in. Disburdening of the economy and households, which had been undertaken in a favourable macroeconomic environment and in the years of peak growth, had already exerted pressure on the balance of public finances when the economy took a turn for the worse in 2008, as the systemic reduction of revenue was not coupled with appropriate measures on the expenditure side. After 2007, the fiscal position started to deteriorate. In 2008, the relative share of primary current expenditure, capital formation and capital transfers surged. Expenditure growth outpaced revenue growth, which was faster than that in GDP given the already weakened economy. In 2009, the general government deficit widened substantially due to the financial and economic crisis. This widening was underpinned by a relative increase in primary current expenditure; investment activity, which was counter-cyclical, continued, and expenditure on interest also started to grow. The growth in the deficit-to-GDP ratio was, however, mitigated with a relative increase in revenue, as revenue dropped more slowly than GDP growth in 2009.

**Figure 18: Contributions to changes in the general government balance, in p.p. of GDP**



Source: SORS, Main aggregates of the general government, First release, 31 March 2010 (for 2006–2009). Non-financial accounts: general government S-13, IMAD calculations.

Note: A positive change in a relative share of the deficit means a reduction of the deficit in the current year compared with the previous year. Increase in expenditure and decrease in revenue are shown as negative values, since they contribute to a widening of the deficit.

share of income tax paid on capital gains. Revenue from this source rose after 2006, when a dual system was introduced, with a lower, single rate of capital-gains tax, which prompted taxpayers to pay out capital gains instead of wages. The remaining group of taxes on capital comprises various property taxes that had already been partially reformed with the tax reform of 2007 (civil taxes), and taxes (real estate) for which reform will be carried out when the conditions are met (appraisal of real estate; see Box 2).

**There is not a great deal of scope for increasing tax revenue with taxes on capital in the short term, but there is potential for changes in some taxes that would make sense due to their positive long-**

**term impact on economic growth and employment (regulation of the real-estate market, reduction of the scope of the grey economy).** The scope for raising tax revenues by replacing the tax on the use of building land with a real-estate tax are limited (see Box 2), but revenue could be increased by expanding the tax base and improving tax collection. In income tax for the self-employed, this could be achieved through simplification of procedures and tax liabilities, which would encourage individuals to register their business and hence reduce the scope of illegal work. By encouraging lessors to register rental income (by changing their tax treatment; Šušteršič, 2010), it is also possible to increase property-tax revenue, but the sums involved are relatively small.

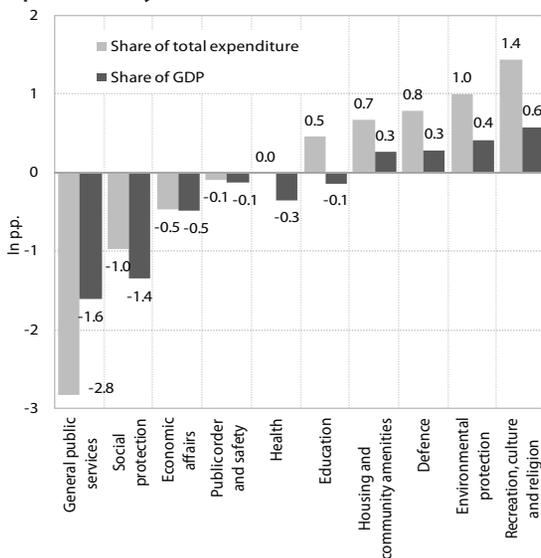
## 7. General government expenditure

### 7.1 Analysis of structure and scope for restructuring

#### 7.1.1. Analysis of government expenditure by function (COFOG<sup>43</sup>)

**Changes in the structure of expenditure by function in the period 2000–2008 were driven mainly by low growth of expenditure on general public services.** Between 2000 and 2008, expenditure on general public services and social protection decreased most in relative terms, whereas expenditure on recreation, culture and religion, environmental protection, defence, housing and community amenities, and education increased most (Figure 19). Available data on the level-II Classification of the Functions of the Government (COFOG II) for the period 2004–2008 show that low growth in this group of expenditure was underpinned by debt-servicing expenditure. Within expenditure on general public services, there was a shift towards other expenditure, including spending on basic research (by 0.6 p.p.), which was favourable in terms of technological development. We estimate that the increase in borrowing for deficit financing in 2009 led to renewed growth in debt-servicing costs

Figure 19: Change in composition of government expenditure by function 2000–2008 (as % of GDP)

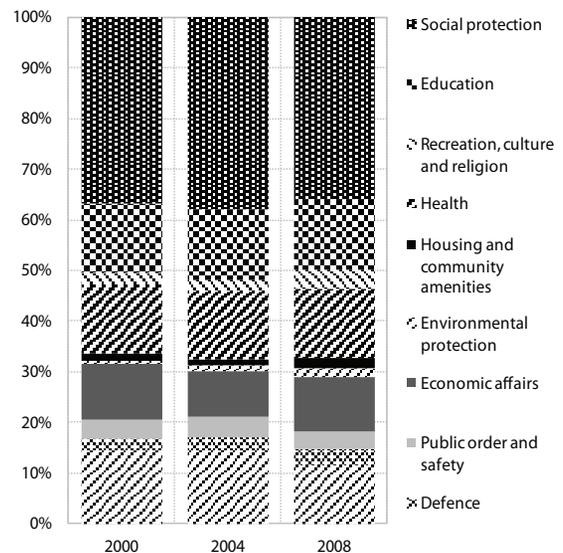


Source: SORS, Ameco.

<sup>43</sup> Classification of the Functions of the Government – COFOG.

and expenditure across the whole group of general public services, and this will continue in coming years (see also Section 9). Given the low growth in total general government expenditure in the coming years stipulated by the Stability Programme – Update 2009, swelling debt-servicing expenditure means that expenditure on general public services will limit and crowd out expenditure on other functions.

Figure 20: Change in structure of government expenditure by function



Source: SORS.

**Over the longer time frame, expenditure on social protection has been below the EU-15 average, whereas expenditure on health and general public services went from above average to below average, while expenditure on environmental protection grew faster and exceeded the average.** The structure of expenditure in 2008 indicates that the bulk of it is social expenditure (63.8%), which is close to the level of the EU-15 average (64.7%), followed by expenditure on general public services (11.4%) and economic affairs (10.5%).<sup>44</sup> Combined expenditure on social protection, health, education and economic affairs was relatively stable in 2000–2008, but structural changes occurred compared with the EU-15: Slovenia had systematically higher expenditure on education and economic affairs throughout 2000–2008. Expenditure on environmental protection was rising and exceeded the EU-15 average, as was expenditure on housing and community amenities, which came close to the EU-15 average in 2008. Expenditure on social protection, however, was systematically lower

<sup>44</sup> For a comparison of the overall structure of general government expenditure by function for Slovenia and the EU average, see Appendix 2.

Table 11: Comparison of Slovenian and EU-average government expenditures by function

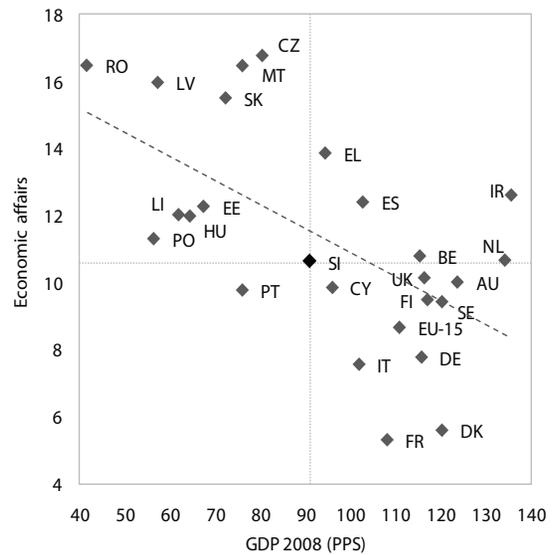
	2000	2004	2008
Social protection	0.92	0.96	0.91
Education	1.20	1.23	1.27
Health	1.04	0.97	0.94
General public services	1.00	1.03	0.83
Economic affairs	1.44	1.11	1.22
Recreation, culture and religion	1.07	1.03	1.64
Public order and safety	0.97	1.03	1.00
Defence	0.63	0.84	0.99
Housing and community amenities	0.58	0.47	0.96
Environmental protection	0.56	0.89	1.21

Source: Ameco.  
Note: higher (lower) than 1 means above (below) average expenditure.

than in the EU-15. Expenditure on health and general public services declined below the EU-15 average, with the fall being particularly significant in the area of general public services in the period 2004–2008.

**Expenditure structure is also conditional on the degree of economic development.** Analysis of expenditure by function over the longer time period for which data for the EU-15 are available (1995–2008)<sup>45</sup> indicates that the relative shares of individual expenditure groups did not change significantly. In the EU-15, the most significant change was reduction of expenditure on general public services and economic affairs. Analysis shows that expenditure on economic affairs and social protection is linked to the degree of

Figure 22: Expenditure on economic affairs relative to per-capita GDP at PPS



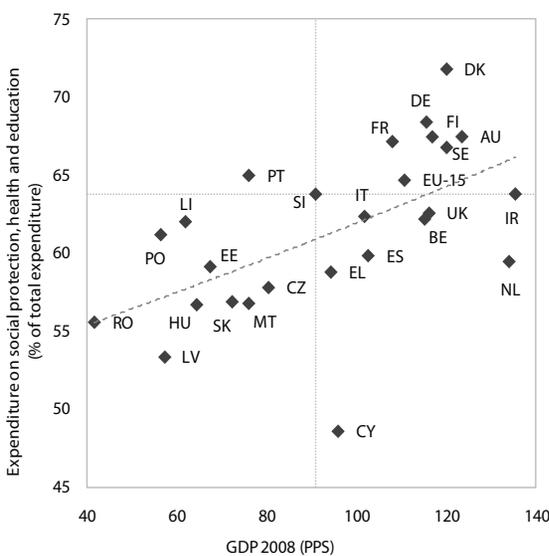
Source: Ameco.

economic development. More developed countries (with higher per-capita GDP at PPS) earmark more for social protection, health and education than for economic affairs.

Comparison of level-II expenditure by function in Slovenia and the EU for key expenditure categories:

- In all countries, the sub-category of expenditure on elderly people is the largest in *social protection*, representing more than 40% of total expenditure in most countries (and 54% in Slovenia). Expenditure on elderly people as a percentage of GDP in 2008 varied from 14.4% in Greece to 3.4% in Ireland. In Slovenia, it stood at 8.6%. The combined share of expenditure on old age and survivors amounted to 10.1% of GDP in Slovenia in 2008. The second largest social expenditure sub-category is sickness and disability benefits. In the 21 EU countries for which data are available, this expenditure varied from 5.3% of GDP in Sweden to 0.3% of GDP in Cyprus and averaged about 2.5% of GDP, the same share that Slovenia spent. On average, the third largest category of expenditure is family and children benefits. Expenditure in this area stood at 2.0% of GDP in Slovenia, while the EU-21 averaged 1.8%, with spending ranging from 3.5% of GDP in Luxembourg to 0.7% of GDP in Spain. The fourth largest sub-category is expenditure on unemployment, which averaged 1% of GDP in the EU-21 in 2008.

Figure 21: Expenditure on social protection, health and education relative to per-capita GDP at PPS



Source: Ameco.

<sup>45</sup> Data for Slovenia are available from 2000 onwards.

Slovenia's share is below average (0.4% of GDP), with the highest spending registered in Germany (2.2% of GDP) and the lowest in the United Kingdom (0.3% of GDP). In 2008, when the impact of the crisis was still limited, expenditure on unemployment was relatively high in countries with more advanced flexicurity models (1.2% of GDP in Sweden and 2% of GDP in Finland).

- In *economic affairs*, the biggest sub-category in EU Member States (except Greece and Denmark) is transport, where the EU average and Slovenia's expenditure stand at 2.5% of GDP. Other important expenditure sub-categories are general economic, commercial and labour affairs, and agriculture. The average expenditure-to-GDP ratio in the EU in both sub-categories was 0.7% of GDP in 2008. The relative importance of these two sub-categories also indicates a link with the degree of economic development: more advanced economies tend to spend more on general economic, commercial and labour affairs, while less advanced economies tend to spend more on agriculture. Slovenia spent slightly more on agriculture (0.9% of GDP) than on general economic, commercial and labour affairs (0.8%) in 2008.
- In the EU-22<sup>46</sup> on average, secondary education (36%) accounts for the biggest proportion of *education expenditure*, followed by pre-primary and primary education (30%) and tertiary education (19%). The structure in Slovenia is similar (37%, 35% and 18% respectively). In primary education and secondary education, expenditure on compensation of employees was relatively higher than expenditure on intermediate consumption, but in tertiary education expenditure in both categories is roughly equal.
- In *health expenditure*, the countries of the EU-23<sup>47</sup> for which data are available spend most on average on hospital services (50%), outpatient services (25%) and medical products (18%). In Slovenia, expenditure on outpatient services is higher than the EU-23 average (34%), while expenditure on hospital services (41%) and medical products (16.4%) is below average.

<sup>46</sup> Level II data on expenditure by function for education are available for 22 EU countries.

<sup>47</sup> Level II data on expenditure by function for education are available for 23 EU countries.

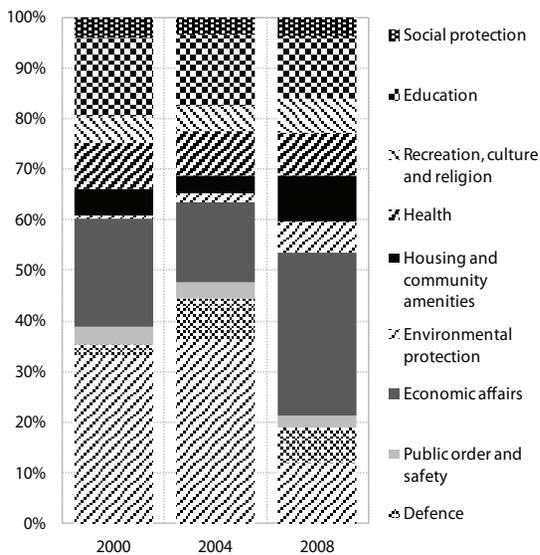
***The combined functional and economic classification additionally explains how expenditure was earmarked by economic function.***

According to the economic classification, Slovenia's expenditure on social benefits and intermediate consumption is below the EU average and expenditure on gross capital formation and compensation to employees above average. The expenditure structure by economic classification in the period 2000–2008 was relatively stable. The bulk of expenditure was allocated for social benefits<sup>48</sup> (38% of the total), with 22.6% spent on pensions and survivors. The EU average is higher (42%) but ranges from 56% in Germany to 22% in Latvia. The second largest component of expenditure in Slovenia according to the economic classification is compensation of employees, which represents about 25% of total expenditure or 11% of GDP (EU average: 22% or 11% of GDP) and was also constant in the period 2000–2008. In Slovenia, the areas with the largest expenditure on compensation of employees ranked according to their relative size in total expenditure are education (8.4%), health (5.2%), general public services (3.5%) and public order and safety (2.4%). Expenditure on intermediate consumption is the third largest expenditure category by economic classification. It represents 14% of total expenditure or 6% of GDP. The EU-average expenditure on intermediate consumption was 6.4% of GDP, and ranged from 12.2% of GDP in the UK to 3.2% of GDP in Luxembourg. The areas with the highest share of intermediate consumption in total expenditure in Slovenia are health (3.5%), education (2.4%), economic affairs (2.4%) and general public services (1.4%). Gross capital formation is the fourth largest expenditure category in Slovenia, averaging 14% of total expenditure and 4.4% of GDP. The observed inverse relation in EU countries between income level and expenditure on economic affairs is also present in terms of gross capital formation and income level. In 2008, the EU-27 average expenditure on gross capital formation in GDP was 2.7%, while in the EU-10 it was 4.5%. General public services and economic affairs account for the bulk of gross capital formation in Slovenia (a combined 50% of the total), but

<sup>48</sup> Social benefits except social transfers in cash and kind that involve products given to households by market producers.

their relative shares have fluctuated over the years. Meanwhile, expenditure on recreation and culture, health, education and social protection remained relatively constant, accounting for about 30% of the total. Over the period 2000–2008, there was an increase of gross capital formation in the areas of defence and environmental protection, whereas expenditure on public order and safety dropped slightly.

Figure 23: Government expenditure on gross capital formation by function



Source: SORS.

### 7. 1. 2. Analysis of the expenditure structure – performance-based budget structure

Performance-based budgeting forms the basis for improving the budgetary procedure, from planning to adoption, and sets the groundwork for determining the efficiency of adopted policies, programmes, projects and individual measures; hence it has a positive impact on the efficiency of public financing. Slovenia adopted this approach to budgeting for 2010, but the methodological framework of the performance-based budget had certain shortcomings. The performance-based budget is still based on the International Monetary Fund's methodology of national financial statistics of 1986, but Slovenia should adopt the methodology of 2001, which would ensure linkage with the methodology of national accounts and make budgeting more precise (see Box 6). The specific weaknesses associated with the currently used methodology are: policy-making which does not follow international standards, and inclusion

of outflows that do not constitute general government expenditure. The policies do not follow international definitions in the Classification of Functions of the Government (COFOG), meaning that the data of the performance-based budget are not even internationally comparable at the primary level (policy level), let alone at lower levels. Moreover, inclusion of outflows that do not constitute expenditure (payment of principal in debt servicing) is in methodological conflict with the definition of general government expenditure. It would therefore make sense to undertake performance-based budgeting in accordance with internationally applicable standards. For analytical purposes, performance-based budgeting should be extended to the entire public finances (the general government sector) and record instruments that are not general government expenditure (e.g. negative taxes in the form of tax breaks and relief, state guarantees). This data would make it possible to undertake a comprehensive analysis of policies, programmes, projects and individual measures. Since the budgeting for 2010 was programme based, the structure of expenditure from this perspective is presented below, despite the mentioned shortcomings.

**In the past, development priorities had not been adequately reflected in general government expenditure, so Slovenia embarked on performance-based budgeting in 2009.** Between 2000 and 2009, Slovenia adopted two strategic development documents: the Strategy for the Economic Development of Slovenia (2000), which covered the period 2001–2005, and Slovenia's Development Strategy (2005) for the period 2006–2013.<sup>49</sup> The development priorities set out in the strategic documents were not appropriately reflected in expenditure, as budgeting had been based on demands by budget users, which largely considered the valid legislation and partial development guidelines. The transition to performance-based budgeting changes the underlying logic of budgeting by putting national development priorities front and centre. In a performance-based budget, expenditure is divided into 13 policies and 3 items for other expenditure.<sup>50</sup>

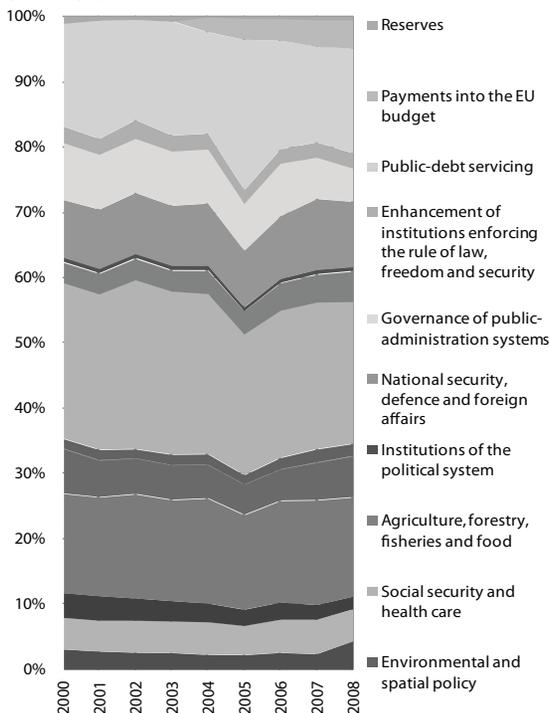
<sup>49</sup> Alongside the two strategies, the government adopted more specific development documents that cover narrower fields.

<sup>50</sup> These policies include: (i) promotion of entrepreneurship and competitiveness; (ii) higher education, science, technology and information society; (iii) the labour market; (iv) education, culture and sport; (v) transport and transport infrastructure; (vi) energy; (vii) agriculture, forestry, fisheries and food; (viii) environmental and spatial policy; (ix) social security and health care; (x) institutions of the political system; (xi) national security, defence and foreign affairs; (xii) governance of public-administration systems; (xiii) enhancement of institutions enforcing the rule of law, freedom and security; and the special expenditure groups public-debt servicing, payments into the EU budget and reserves.

Of the 13 policies, 9<sup>51</sup>,<sup>52</sup> covering economic, social and environmental development are defined as having a significant impact on development. Performance-based budgeting assumes that Slovenia's budget comprises a programme basket, a basic social safety net, and the management of public debt, claims and payments into the EU budget. In the first phase, the programme basket includes development policies with all programmes and sub-programmes, as well as other, predominantly state-building, policies. Slovenia started applying this approach in 2009 and used it on a test basis in the 2010 budget.

**Analysis of the structure of expenditure according to development-oriented budgeting for the period 2000–2008 shows that changes in the shares of all groups of expenditure were quite even.** Expenditure structure by policies shows that spending on development policies, which on average account for 60% of total expenditure, declined steeply in

Figure 24: Structure of general government spending by policy groups, 2000–2008, %



Source: Records of the Government Office for Development and European Affairs (GODEA), April 2010.

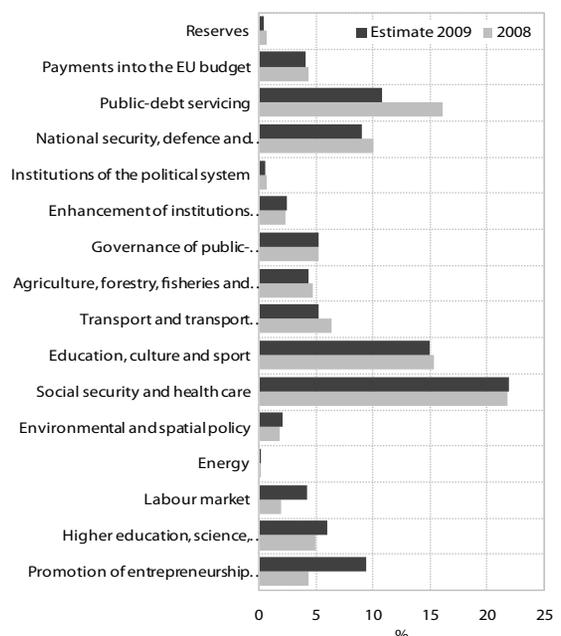
<sup>51</sup> The programme budget classifies the following as development policies: (i) promotion of entrepreneurship and competitiveness; (ii) higher education, science, technology and information society; (iii) the labour market; (iv) education, culture and sport; (v) transport and transport infrastructure; (vi) energy; (vii) agriculture, forestry, fisheries and food; (viii) environmental and spatial policy; and (ix) social security and health care.

<sup>52</sup> Lautar and Klužer (2009, p. 89) do not include agriculture, forestry, fisheries and food under development policies.

2000–2005 (2000: 62.3%, 2005: 54.9%), whereupon it slowly increased until 2008 (60.9%). Expenditure on state-building policies hovered around 20% in this period, with the exception of 2005 and 2008, when it dropped to around 18%. The changes in expenditure on development and state-building policies are also a consequence of changes in other expenditure, i.e. debt servicing (including interest as well as principal, the latter not being a part of general government expenditure according to international methodologies) and payments into the EU budget. This expenditure fluctuated in 2000–2008, ranging from 15.9% in 2002 to 26.6% in 2005. Throughout the eight-year period, the adopted development priorities do not seem to have altered the ratios between these three groups of expenditure.

Among **development policies**, the share of expenditure of which dropped between 2000 and 2008, some policies gained and others lost, but development priorities were reflected in spending to a limited extent only. Promotion of entrepreneurship and competitiveness; higher education, science, technology and information society; energy; agriculture, forestry, fisheries and food; and environmental and spatial policy gained 3.2 p.p. Social security and health care; education; culture and sport; labour market; and transport and transport infrastructure lost 4.6 p.p. Policy areas where expenditure increased include those that have no or no significant impact on development. Conversely, policies where expenditure dropped include those that can have a decisive impact on development.

Figure 25: Change in expenditure by policies, %, 2008 and 2009



Source: GODEA records, April 2010.

**Box 5: Assessment of budgeting procedure and accompanying documents<sup>1</sup>**

Budgeting in Slovenia must change to become more efficient. The main shortcomings refer to the following aspects of budgeting: (1) consideration of the global expenditure framework; (2) unrealistic planning as a result of the lack of linkage between development planning and budget documents; (3) determining the efficiency of expenditure programmes; and (4) budget co-ordination and documents (proposed financial plans by budget users and plans of development programmes). Even when adopted budgets are relatively development-oriented and in accordance with the priorities set out in the budget memorandum, subsequent changes (supplementary budgets) and budget realisation often fail to consider development priorities. Supplementary budgets or reduction of expenditure are usually linear and affect all budget users, who tend to primarily reduce development-oriented expenditure. Expenditure cuts are linear because Slovenia does not have appropriately framed expenditure policies. Inappropriate expenditure programmes and lack of transparency are also the main reasons why Slovenia does not have an adequate system for determining the efficiency of expenditure programmes. Old programmes tend to be wound down very slowly, they are frequently only restructured while new programmes are added, which only increases the demand for expenditure. Another major problem is the way expenditure is co-ordinated: on the basis of annual financial plans of budget-users that lack a longer-term temporal and programming continuity. Very fragmented budget items are also a major obstacle in co-ordination: they change significantly through the years in formal terms even though the content remains practically the same. A solution in the form of more complex plans for development programmes has yet not been arrived at, as the number of documents of this kind has also been increasing substantially through the years.

To rectify these problems, a performance-based budget is expected to gradually introduce changes to budgeting procedures and accompanying documents, including: a fiscal rule, a performance-based budget, monitoring and measuring efficiency of development policies, and a link between development planning and budgeting. The introduction of a fiscal rule is intended to tie the increase in expenditure to potential GDP growth, which would determine a global framework of expenditure and limit spending rises during the budget debate in government and parliamentary procedure. A performance-based budget is based on formation of comprehensive programmes, sub-programmes and expenditure measures by policies, which would replace fragmented budget items and steer the budget debate away from individual items and budget users. A development-oriented budget ought to be upgraded with measurable goals and indicators to measure the effects of programmes, projects and individual measures. A system of this kind would help exclude ineffective programmes from public financing and lead to a preliminary assessment of the potential efficiency of new programmes and measures. Efficiency estimates of individual programmes, projects and measures within each policy, and an assessment of development in the field covered by each policy, would make it possible to assess the overall efficiency of policies. The current inappropriate linkage between development planning and budgeting is also highlighted by the Slovenian Exit Strategy 2010–2013 (2010). This link should be enshrined in amendments to the decree on development planning. Changing budgeting by instituting multi-year development priorities would ensure continuity in implementation of efficient development programmes, along with the ongoing exclusion of inefficient and the reform of insufficiently efficient development programmes, and would achieve transparency of spending.

<sup>1</sup> Assessment of the budgeting procedure and the accompanying documents is laid out in detail in Appendix I.

These trends indicate that in 2000–2008, Slovenia did not pursue a consistent development policy methodically supporting development priorities.

*In state-building policies, expenditure on national security, defence and foreign affairs increased in 2000–2008, but spending on other policies decreased. Expenditure on national security, defence and foreign affairs rose from 2000, in particular in 2006 and 2007 (2000: 8.9%, 2007: 10.9%), primarily in defence and civil protection (achievement of NATO commitments) and foreign policy. Expenditure on governance of*

public-administration systems dropped significantly, from 8.8% in 2000 to 5.1% in 2008, most notably in programmes of governance of public-administration systems at state and local levels, as well as economic and fiscal policies. Expenditure on enhancement of institutions enforcing the rule of law, freedom and security, and institutions of the political system is small and did not change in this period.

***The recession and mitigation of its consequences altered the expenditure structure in 2009 and significantly increased spending on development policies, which rose 6.9 p.p. over the previous***

**Box 6: Transition to a new methodology of national financial statistics**

**Slovenia still uses the outdated 1986 International Monetary Fund (IMF) methodology for government finance statistics and budgeting.** With the specifics of public finances in mind, the IMF developed a special methodology for government finance statistics back in 1964. The system is designed to measure and forecast the fundamental ratios in public finances, and the classification of government transactions is conceived so as to provide analytical and planning tools for government policies. Analysis of the 1986 methodology showed a number of faults (Premchand, 1995, pp. 64–70): (1) The system does not cover all transactions, only those derived from the budget system. For special budget accounts, only consolidated data are available; (2) Transactions are mostly recorded using the cash basis. Cash basis accounting does not provide data on the type of transaction and does not support use of assets or value inventories, etc. Expenditure is therefore measured incorrectly; (3) The methodology does not require separation between current and capital accounts; (4) The budget system has a general item for long-term purposes (longer than a year), which is capped and typically financed with debt; (5) The acquisition and valuation of assets has numerous weaknesses, and assets are thus not appropriately valued; (6) Capital transfers are stated in the budget, but data are limited to flows; (7) For financial assets and credits (as well as shares and investments) the budget system (and the accounting system) record only flows but not inventories; (8) Under the budget system, devaluation is included in budgets only in certain systems. These weaknesses also affect the statement of public finances in Slovenia: revenue and expenditure are underrated (e.g. depreciation is not considered) and the differences between actual (invoiced) liabilities and payments (e.g. in taxes) are not stated.

**Most of the weaknesses of GFS 1986 were redressed by changes to the IMF's methodology in 2001 (Government Finance Statistics 2001 – GFS 2001),** including double-entry bookkeeping of flows, a balance sheet, and changes in acquisition and valuation of certain transactions. The most important change involves the transition from the cash basis to the accrual basis, the main benefits being better comparability of information stated in a period, solution of problems stemming from incomplete databases (transactions in kind) and better linkage to the system of national accounts. The transition to the accrual basis, whereby the methodology also allows for statement of transactions on the cash basis, and the convergence of government finance statistics with national accounts, also changes the definitions and classification of transactions. Differences are significant even for individual invoices, and all the more for classification of transactions and flows. There are three main groups of transactions (Government Finance Statistics Manual, 2001, pp. 39–42): revenue and expenditure, transactions in non-financial assets, and transactions in financial assets and liabilities. The first group includes revenue and expenditure. All transactions that increase the net worth of the general government sector are classified as revenue. They are divided into taxes, social contributions and other revenue. All transactions that decrease the net worth of the general government sector are classified as expenditure. Expenditure is divided into: compensation of employees, use of goods and services, consumption of fixed capital, interest, subsidies, grants, social benefits and other expenditure. The second group comprises transactions in non-financial assets, which includes all transactions that change non-financial assets (fixed assets, inventories, valuables and non-produced assets). The third group, transactions in financial assets, records transactions that change a government's holdings of financial assets and liabilities. They are classified by instruments and sectors.

**The transition to GFS 2001 will provide a more realistic statement of public finances and, consequently, enable more comprehensive and consistent fiscal policy-making.** By joining the EU, Slovenia adopted the European System of National and Regional Accounts (ESR 2005, Eurostat), which is also a general standard for government financial statistics and largely compliant with the United Nations system of national accounts upon which GFS 2001 is based. The GFS 2001 standard has already been adopted by the majority of EU and OECD members. Slovenia has announced several times it would commence preparations for the adoption of GFS 2001, but after nine years this is yet to happen. Implementation of this forecast in the Stability Programme – Update 2009 is therefore urgent to provide a more realistic picture of public finances, to achieve comprehensive, consistent management of policy, and to align methodology with other developed countries. But the adoption of the new standards will undoubtedly be a long process. A survey carried out among IMF members in 1996 revealed that of the 170 countries, only 29% (38% of industrialised countries) had been able to state data for all levels of government on the accrual basis. In a period of five years, no more than 40–60% of these surveyed countries will be able to adapt their present reporting systems to the new standards (Efford, 1996, p. 20). The situation is similar in the OECD, as only three countries had fully implemented the system of invoiced realisation by 2000 (Brumby, Cangiano, 2000, p. 19). Post-socialist countries have particular difficulty in reporting transactions in compliance with the GFS 2001 system: there are problems even with coverage of public finances reports and their aggregation, as well as with restructuring of inappropriate classifications that do not cover the economic characteristics of the transactions (Montanjees, 1995, p. 50).

**year to 67.8%.** Expenditure on promotion of entrepreneurship and competitiveness doubled in 2009 (a 5.1-p.p. increase), labour-market expenditure trebled (up by 2.3 p.p.) and expenditure on higher education, science, technology and information society also increased significantly (by 1.0 p.p.). Smaller spending increases were recorded in energy, environmental and spatial policy, and in social security and health care. These increases were achieved with a 1.8-p.p. reduction of spending on other development policies (education, culture and sport; transport and transport infrastructure; agriculture, forestry, fisheries and food) and a 1.0-p.p. drop in spending on state-building policies, in particular national security, defence and foreign affairs (see Figure 25).

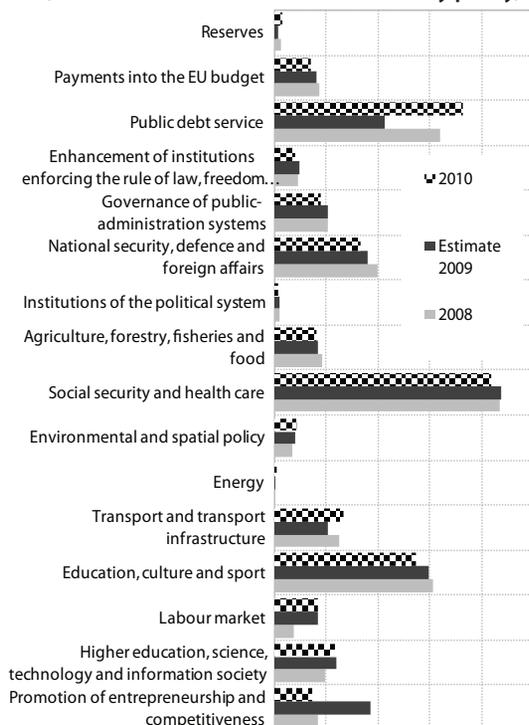
**In the adopted 2010 budget, expenditure on development policies was already projected to drop over 2009, but the supplementary budget that the government adopted in June further cut spending according to our estimate.** The adopted budget for 2010 cut expenditure on development policies compared with the year before, in particular on promotion of entrepreneurship and competitiveness, education, culture and sport, and social security and health (by a combined 7.5 p.p.). Spending cuts, albeit smaller, were also planned for higher education, science, technology and information society, and

agriculture, forestry, fisheries and food. Expenditure on transport and transport infrastructure was slated to increase substantially and expenditure on labour market and two development policies that account for a smaller share of expenditure (energy and environmental and spatial policy) was also projected to continue to rise. However, the 2010 supplementary budget was not structured along programming priorities, which interrupted the early stages of the process of qualitative change in budgeting that was supposed to form the basis of restructuring of expenditure towards a greater emphasis on development (see also Box 5). Nevertheless, based on the available data, we have estimated the reduction of expenditure by policies and arrived at the conclusion that the supplementary budget for 2010 will further decrease expenditure on development policies, as about two-thirds of the total expenditure cuts were achieved in development-oriented policies, most notably in transport and transport infrastructure.

## 7.2. Efficiency of state aid in affecting market structures<sup>53</sup>

**State aid in Slovenia is slightly above the EU average and its distribution is very sectoral even in horizontal measures.** In 1998–2008, Slovenia granted state aid of just over EUR 2.8 bn (excluding aid to farmers), with the largest share channelled to manufacturing and transport (see Figure 27). The bulk of state aid for transport was granted to the railways for the performance of public service and coverage of losses that the railway company has been incurring throughout the period for which Slovenia has reported state aid. Other major recipients of state aid (by order of importance) include business services, general public services, mining, retail and wholesale trade, and education. Particularly at the start of this period (1998–2000), general public services received significant amounts of aid for agriculture, which was disbursed to final recipients. In the later period (2005–2008), this aid dropped significantly, but it is still problematic, since there is no overview of final recipients. Substantial aid to education and, to a lesser extent, business services is related to research carried out by research and higher-education institutions. Aid to retail and wholesale trade was allocated to agriculture. Coal mining received aid under special legislation introduced on the closure of coal mines. In manufacturing, state aid over the decade (1998–2008) was channelled primarily to the food processing, paper, metal, machinery and vehicle-manufacturing

Figure 26: Structure of planned expenditure in 2010 (budget adopted in December 2009) compared with 2008, with estimate of realisation for 2009 by policy, %

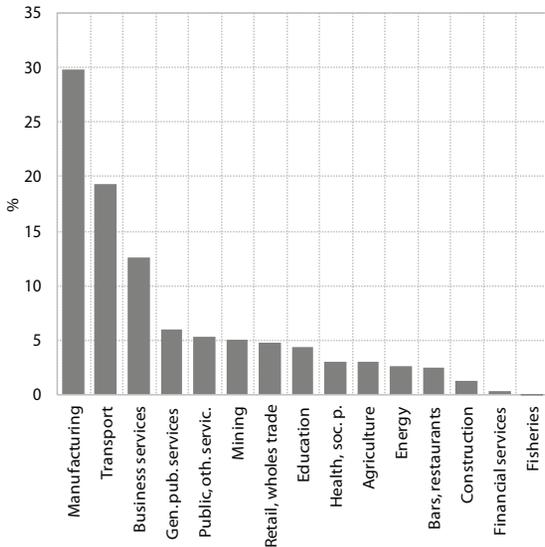


Source: GODEA records, April 2010.

<sup>53</sup> The findings are based on the target research-programme study no. V5-0408 Kako do večje učinkovitosti razporejanja javnofinančnih sredstev: Analiza učinkov državnih pomoči na omejevanje konkurence (How to achieve more efficient allocation of fiscal resources: Analysis of the impact of state aid on competition distortions).

industries. These industries received over half of all state aid granted to manufacturing through the period. In terms of technological intensity, the bulk of aid was earmarked to technologically less intensive industries. In the later period (2005–2008), aid to technologically more intensive and hi-tech industries rose substantially, but this is a consequence of the aid granted to a single company. Excluding this company, the policy of state aid in this period failed to change towards giving the state a

Figure 27: Distribution of state aid (excluding aid to farmers) by sector, %, 1998–2008

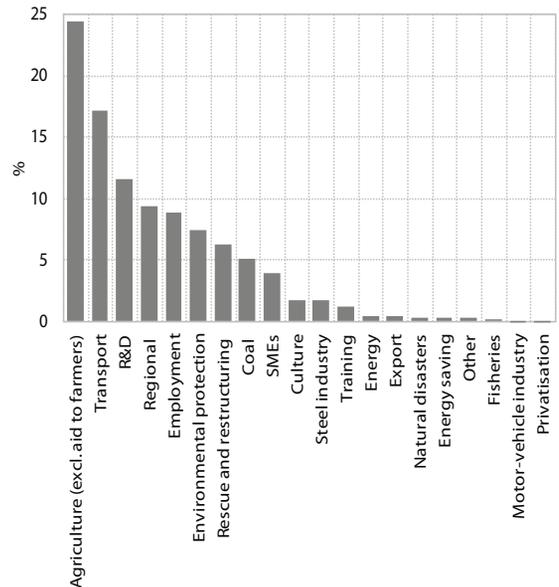


Source: Records of state aid.

more active role in promoting the development of more technologically intensive industries.

**State aid (excluding aid to farmers) capable of providing a significant boost to economic development (research and development, training, small and medium-sized enterprises) accounted for just 16.7% of the total aid in the period 1998–2008.** Almost half of state aid to companies was sectoral, dedicated to helping solve problems faced by agriculture, fisheries, motor vehicles industry, steel industry, the energy sector, the coal mining sector and the transport sector. Looking at the shareholder structure of recipients of sectoral aid, the government primarily helped companies in which it is a shareholder. Aid for rescue and restructuring and employment accounted for 15% of total aid and was earmarked in particular for addressing social problems in uncompetitive manufacturing firms. Aid was thus targeted at industries with low technological intensity, which are also the main beneficiaries in manufacturing. This aid provided a lifeline for less efficient firms that needed to adapt production to European and global economic trends. Industries with low technological intensity received a mix of restructuring and development aid. Hi-

Figure 28: Distribution of state aid (excluding aid to farmers) by function, %, 1998–2008



Source: Records of state aid.

tech industries, which account for a relatively small proportion of the economy in Slovenia, received primarily development aid, but the scope of this was small. In other industries, sectoral aid (for agriculture) accounted for the bulk of aid in retail and wholesale trade and other public and personal services; bars and restaurants received mostly regional aid, the construction industry mostly employment aid, and business services and education mostly development aid (for research and development).

**State aid is a vital instrument of competition policy and can reduce market concentration and promote competition; however, in Slovenia, it was largely not used for these purposes in 1998–2008.** Statistical analysis of market concentration<sup>54</sup> confirmed high concentrations, but this is not unexpected in a small economy such as Slovenia's. In 2007, high market concentration was recorded in nearly half (45.9%) of all sectoral groups. If state aid was directed at smaller companies and producers with high growth potential, concentrations would have been gradually reduced and competition improved. Slovenia, however, mostly used state aid to support big producers. In 56% of sectoral groups, it was the biggest producer that received state aid. In manufacturing, the ratio is even worse, as the biggest producer received state aid in as many as 78% of all sectoral groups. Since the biggest companies also received relatively large sums, state

<sup>54</sup> The statistical analysis was carried out with the Herfindahl-Hirschman index (HHI), a method of analysing market shares of one, three and four of the biggest companies in the sectoral group (SKD-3) and new market entrants.

aid typically hampered competition and increased market concentration.

**State aid has affected the relatively important channel of reallocation<sup>55</sup> of production factors and output by preventing companies from exiting the market; in allocation efficiency,<sup>56</sup> meanwhile, aid did not have an impact on market efficiency as a catalyst of efficiency and filter of inefficiency.**

Various methodological approaches (models) confirmed that state aid in Slovenia caused some market distortion and restricted competition in 1998–2008. Existing companies retained their market shares, preventing more productive companies from utilising employees and capital from poor performers. However, the aggregate economic impact of this measure was relatively small compared with the contribution of the company's exit to the growth of productivity in the whole sector. In terms of allocation efficiency, state-aid programmes were neutral on aggregate, but preliminary analyses of individual state-aid programmes showed that some types of aid were inefficient and distorted the structure of the market. On average, state aid has a positive impact in raising the market shares of beneficiaries, but in terms of allocation efficiency the impact was relatively neutral. Receipt of aid in a previous year or any year before that was associated with an increase in productivity. Receipt of aid in previous periods improved productivity of beneficiary companies in the range of 1–2 p.p.<sup>57</sup> a year. The total impact of state aid on market competition was thus neutral: aid improved beneficiaries' productivity on average and the improvement reflects in increased market share.

**In 1998–2008, state aid in Slovenia did not sufficiently pursue the objectives of industrial and competition policies.** Even though the combined impact of state aid on competition is neutral, the fact remains that the bulk (too much) of state aid

is granted to large rather than small or medium-sized enterprises, which would have been more in line with the theory of potential positive impacts of state aid on development. The neutral effect of state aid on the allocation efficiency of the Slovenian economy shows that state-aid policy is essentially not development-oriented. Too much aid has been spent on salvaging companies – in particular those owned by the state – and on social problems in non-competitive firms. Too little is being spent on aid that can accelerate economic development (research and development, training, small and medium-sized enterprises).

**Industrial policy of this kind has been a factor behind the slow restructuring of the Slovenian economy. It has hampered not only economic but also social development and the rational utilisation of natural resources.**

Limited public finances means that state aid can no longer offset the revenue shortfall of companies that are becoming less and less competitive in the global arena (in particular in labour-intensive industries and industries with heavy natural-resource requirements). The upshot is a relative decline in labour costs (wages), gradual deterioration of employees' social security and increased use of natural resources in these firms (Rojec et al., 2010. p. 87). Slovenia's future economic development must be based on technological breakthroughs, which can only be achieved with measures that include far-reaching changes to the policy of state aid. This policy must change in four ways. Firstly, non-productive and less productive functions of state aid (sectoral aid, salvaging and restructuring, job preservation) need to be reduced to the lowest level possible and development-oriented state aid (research and development, training, small and medium-sized enterprises) needs to increase substantially. Secondly, the excessive fragmentation of aid must be remedied; small sums do not produce the desired effects but the state nevertheless incurs transaction costs. Thirdly, aid should be granted predominantly to young firms that have good growth prospects or entirely new products, and innovative start-ups that have found niche markets. Fourthly, the market position of potential recipients relative to the competitors and to complementary products ought to be included among the criteria for state aid, and the impact of state aid on the competitiveness of the beneficiary against the potential for restriction of competition assessed, in particular for large beneficiaries.

<sup>55</sup> The analysis was carried out for the most important aspects of competition: market concentration, entry into and exit from the sector, market shares, productivity and margins. Different methodological approaches were used for industry- and company-level analysis.

<sup>56</sup> The analysis was made for impact of state aid on market share, productivity and companies' decision to exit the market.

<sup>57</sup> The calculation was made based on six measures of productivity: value added per employee; total factor productivity using the panel data model with fixed effects; total factor productivity by the Olley-Pakes method with value added and sales as output measures; total factor productivity by the Levisohn-Petrin method with value added and sales as output measures. The results were positive and significant in three of the six productivity measures, non-significant in two, and negative and significant in one – the indicator of receipt of aid at any time in past periods.

### 7.3. Fiscal rule<sup>58</sup>

**The consolidation of public finances ought to include the introduction of a fiscal rule, but even the best economic policy rule is efficient only if the policy makers adhere to it.** The bailout of financial institutions and discretionary expansionary fiscal policy measures during the financial and economic crisis have led to surging debt levels in many countries, including Slovenia, which is additionally facing the problem of growing ageing-related expenditure and high implicit liabilities which, if classified as debt, would take general government debt close to the Maastricht ceiling of 60% of GDP (see also Sections 4 and 5). With these factors working together, it is clear that the preservation of the status quo in fiscal policy leads Slovenia into a position where a return to crisis on the scale of the present one could quickly transform it from a country with medium levels of debt to a highly indebted country, very vulnerable to refinancing conditions on the international financial markets. To consistently manage expenditure growth, consolidation ought to include the introduction of a fiscal rule, which had been recommended to Slovenia as an effective way of managing fiscal policy after EMU<sup>59</sup> entry and has been indicated by the present government in the Stability Programme – Update 2009.

**Use of fiscal rules is widespread in developed countries.** Fiscal rules are a collection of formal regulations on fiscal-policy management. Indeed, the fiscal Maastricht Criteria and provisions of the Stability and Growth Pact can be considered fiscal rules. Two fiscal rules that the United Kingdom has used are an example of stricter rules that have turned out to be relatively successful. The *Golden Rule* determines that the government may borrow only to invest, and even this borrowing may only be carried out within the period of the economic cycle. Current spending may not be funded with borrowing. The *Sustainable Investment Rule* requires that net public debt must remain below 40% of GDP throughout the economic cycle. Until the crisis hit in 2008 and the definition of the economic-cycle period became subject to manipulation, the UK was considered an example of very good practice in fiscal policy, but its case also serves to show that even the best rule is good only if policy-makers abide by it. Another example

of best practice is the *expenditure fiscal rule*. Put simply, the rule limits growth in budget expenditure by the level of growth of potential nominal output.<sup>60</sup> Such a rule applies in Sweden, which uses it to cap budget-expenditure growth (including pensions but excluding local government expenditure) for the next three-year period. Additionally, target expenditure growth must adhere to the goal of a 1% budget surplus over the economic cycle, it must be consistent with long-term sustainability of public finances and it must be oriented towards a pre-determined decrease in expenditure as a share of GDP. The latter creates room for fiscal disburdening of the economy without jeopardising the sustainability of public finances.

**Sweden is an example of good practice in the use of fiscal rules: during the time it has applied the fiscal rule, it has achieved a sizeable improvement in the structure of its public finances and boosted the efficiency of its fiscal policy.** Persistent deficits have been largely replaced by surpluses. Sweden's public debt dropped from 73% of GDP in 1996 to 40% in 2008, well below the EU average. In its report on the sustainability of public finances released in autumn 2009, the EC estimates that alongside Denmark, Sweden is in the best position regarding sustainability of public finances (European Commission, 2009). Even though it is difficult to say to what extent this may be attributed to independent monetary policy, Sweden is considered to have approached the onset of crisis very well prepared. In crisis, its debt will rise only marginally (The EC expects only the Czech Republic to record a lower debt increase) and its growth prospects are above average.

#### **Positive characteristics of the expenditure fiscal rule**

- Improved transparency of fiscal policy.
- Improved *stabilising efficiency of public finances*. Since expenditure growth does not change through the economic cycle, the rule allows for full operation of automatic fiscal stabilisers. The expenditure rule is typically coupled with a mid-term surplus target. This creates a safety barrier before the 3% deficit ceiling and precludes the need for inefficient fiscal consolidation during a crisis.
- The cap on expenditure growth provides an *anchor for achieving sustainability of public finances* and forces ministries to economise spending. The end effect is stabilised debt (deficits in times of crisis are offset by surpluses in periods of above-average growth).
- *Temporally inconsistent actions by the government are restrained*. This prevents a policy of politically motivated fiscal

<sup>58</sup> The section is based on a paper by Igor Masten, PhD, "Izdatkovno fiskalno pravilo v Sloveniji v luči javnih financ po izhodu iz krize" (Expenditure fiscal rule in Slovenia in the light of public finances after the exit from the crisis).

<sup>59</sup> Coricelli and Masten (2006) also showed that the stabilising efficiency of fiscal policy in Slovenia would significantly improve with such a rule.

<sup>60</sup> Potential growth in real GDP plus target inflation.

expansion before elections.

- Given appropriate mid-term orientation, it provides a consistent framework for tackling the fiscal problem of population ageing.
- Mid-term focus limits the scope for permanent spending increases in the event of substantial one-off fiscal inflows (e.g. privatisation revenue or housing bubbles).

**Examples of good practice show that it is sensible to introduce a fiscal rule in Slovenia. However, the key parameters of the rule need to be adapted to the specific circumstances, in particular the baseline figures and pressure on the long-term sustainability of public finances.** Sweden's example shows that the key parameters of an expenditure fiscal rule are: time horizon, selection of a mid-term structural budget-balance target, determining a target rate of expenditure growth, and allowance for correction of parameters due to baseline deficit/surplus. However, these are parameters of Sweden's fiscal rule, which has been applied over an extended period, during which certain midterm fiscal consolidation objectives have already been achieved. In Slovenia's case, the fiscal rule should include "corrective factors" to factor in the current state of long-term sustainability of public finances and the baseline structural deficit.

**During the period of consolidation, an expenditure fiscal rule based on potential GDP growth should be more restrictive.** The Stability Programme mentions the use of a fiscal rule based on potential GDP growth. For a rule of this kind to be efficient, target expenditure growth should be set based on estimates of potential economic growth taking into account the impacts of the economic and financial crisis. A (maximum) reference rate of expenditure growth over a multi-year period depends on estimates of potential output. Previous estimates for Slovenia (Jongen, 2004) set it at 3.6%, but the financial and economic crisis of 2008–2009 introduced an additional level of uncertainty by a series of factors that may have a permanent negative effect on trend economic growth (European Commission, Sustainability Report, 2009):

- Higher costs of foreign financing as the financial sector is restructured
- Lower growth in total factor productivity as investments grow at a slower pace
- Reduction of human capital due to an increase in long-term unemployment
- Reduced consumer confidence and demand on the domestic market as well as in the developed countries that are Slovenia's export markets

The expenditure-growth target should thus be based on new estimates of Slovenia's potential output. In

view of the above-mentioned negative factors, it should be much more restrictive in the short term. The primary downside factor is the excessive baseline structural deficit, which we estimate at 3.8% of GDP in 2009 and 4.4% of GDP in 2010. Taking into account debt-financing costs, Slovenia's primary structural deficit will be in the 3% of GDP range. Calculations by the European Commission (European Commission, Sustainability Report, 2009) show that to achieve a primary budget balance that stabilises public debt, the deficit must be reduced by almost 4% of GDP.

**Consolidation of public finances should be underpinned by a reduction of expenditure as a share of GDP taking into account the target debt-to-GDP ratio.** Considering the economic situation, the scope to raise revenue is relatively limited (see also Section 6), making far-reaching expenditure-side cuts a necessity. General government expenditure rose to 49% of GDP in 2009 (see also Section 2), having averaged 45.2% of GDP in the period 1999–2008 (which can be considered as a cyclically adjusted approximation). A 4-p.p. cut would reduce expenditure to about 41% of GDP. Expenditure growing below potential over a certain period would achieve two goals. Firstly, the balance needs to be consolidated by 4% of GDP, bringing public finances into a position where the fiscal rule can operate in its balanced form. Secondly, expenditure needs to be reduced by the corresponding share of GDP. Add to this the issue of targeting debt-to-GDP ratio: due to the crisis, debt is projected to nearly double, making Slovenia a country with mid-level indebtedness and taking it into the territory of increased vulnerability to fiscal crisis in the event of a renewed recession. To preserve the resilience of the Slovenian public finances to such events, it makes sense to bring the debt-to-GDP ratio back to pre-crisis levels. This will require an additional reduction of the target expenditure growth over a transitional period.

**In a period of uncertain economic recovery, the pace of expenditure cuts needs to be weighed in terms of its impact on economic activity.** How expenditure growth should lag behind potential output growth in the transitional period depends on the duration of the transition. In making this decision, it is necessary to balance the necessity of timely action for sustainability of public finances with a continuation of an expansionary fiscal policy aimed at kick-starting growth. If fiscal-policy tightening is premature, the resulting deterioration in the economic environment could jeopardise the achievement of fiscal sustainability. In any case, consolidation needs to be completed before the burden of ageing-related expenditure starts to grow at a faster pace.

**Box 7: IMD analysis of government efficiency**

**After a significant improvement in Slovenia's global competitiveness in 2009 as measured by the IMD,<sup>1</sup> Slovenia plunged in the rankings, due among other factors to a significant drop in government efficiency in all main areas,** itself a result of a major deterioration of selected indicators and very low subjective estimates.<sup>2</sup> Slovenia held the 32<sup>nd</sup> spot among 57 nations in 2009, but in 2010 dropped to 52<sup>nd</sup> among the 58 countries included. Government efficiency, consistently Slovenia's worst rated component of global efficiency, had improved substantially in 2009 (38<sup>th</sup> place) but plunged to 53<sup>rd</sup> in 2010.

Table 12: IMD: Government efficiency, ranking

	2004	2005	2006	2007	2008	2009	2010
Public finance	23	16	24	17	21	14	44
Fiscal policy	46	46	49	47	51	49	53
Institutional framework	41	39	37	35	33	30	46
Business legislation	41	46	45	51	47	39	49
Societal framework	35	30	29	31	37	30	46
<b>Total government efficiency</b>	<b>40</b>	<b>42</b>	<b>43</b>	<b>43</b>	<b>43</b>	<b>38</b>	<b>53</b>

Source: IMD World Competitiveness Yearbook 2010.

**Government efficiency severely deteriorated in 2010 in the area of public finances (a drop from 14<sup>th</sup> to 44<sup>th</sup>), whereas fiscal policy has had a low ranking for several years.** Slovenia's 14<sup>th</sup> rank in public finances<sup>3</sup> in 2009 was based on the low general government debt and deficit in the previous years, while the result was worse for total general government expenditure and tax evasion. In 2010, Slovenia plunged to 44<sup>th</sup> as a result of low ratings of indicators that show debt and deficit growth relative to GDP (indicators that show debt and deficit levels did not drop so much) and subjective estimates. The tax-evasion indicator has a very low subjective estimate, whereas the subjective component of the management of public finances and pension-funding indicators declined significantly. Slovenia has had a traditionally low rating for fiscal policy,<sup>4</sup> and the improvement in 2009 proved transitory as the 2010 ranking was the worst since 2004 (53<sup>rd</sup>). Slovenia's low rankings have been based on indicators that show taxes on consumption, social-security contributions per employee and the effective rate of personal income tax, and in 2010, particularly on low subjective estimates of the stimulating effect of personal and corporate taxes.

**Ratings for the institutional framework, business legislation and societal framework are based largely on subjective estimates provided by a survey of executive opinion. The assessment of institutional and societal framework declined substantially in 2010.** Within the institutional framework, the rating of the central bank was better than that of state efficiency, with the latter dragged down by much worse estimates of adaptability of government policy, government decisions, bureaucracy and corruption. Estimates in the area of the societal environment did deteriorate, but, other than the ageing of society, these are not low. The business-legislation factor deteriorated, with the main weaknesses being foreign investment, capital markets and the labour market, which have been low for several years and dropped further in 2010.

<sup>1</sup> IMD World Competitiveness Yearbook (May 2010).

<sup>2</sup> Indicators are based on data for 2009 and estimates on the situation in early 2010.

<sup>3</sup> The following indicators are used in public finances: government budget surplus/deficit (in US\$ bn), government budget surplus/deficit (as % of GDP), total general government debt (in US\$ bn), total general government debt – real growth (in %), domestic/foreign central government debt (as % of GDP), interest payment (as % of current revenue), management of public finances (improved/worsened), pension funding (adequate/inadequate), tax evasion (hampers/does not hamper public finances) and total general government expenditure (as % of GDP).

<sup>4</sup> The following indicators are used for fiscal policy: Collected total tax revenues (as % of GDP), collected personal income tax (as % of GDP), collected corporate income tax (as % of GDP), collected indirect-tax revenues (as % of GDP), collected capital and property taxes (as % of GDP), collected social-security contribution (as % of GDP), effective personal income tax rate (%), corporate tax rate on profit (%), consumption tax rate (%), employee's social security contribution rate (%), employer's social-security contribution rate (%), real personal taxes (encourage/discourage), real corporate taxes (encourage/discourage).

**To achieve and preserve a sustainable fiscal position, the fiscal rule ought to be targeted at a surplus over the long term.** The appropriate time horizon for an expenditure fiscal rule should be a multi-year period. The selection of a mid-term structural balance is primarily conditional on managing the financing of the demographic transition. Without this, EC calculations show that debt stability could be maintained in principle even with a moderate target deficit (0.5% primary surplus minus the cost of interest on public debt) with budget-expenditure growth matching growth rates in potential output. However, these calculations are overly optimistic. Firstly, they are based on the pre-crisis level of public debt, which has surged during the crisis. Secondly, they presume a return to economic growth at pre-crisis levels, but the crisis may in fact permanently reduce output. These calculations also neglect the long-term costs of ageing. The financing of the demographic transition thus requires a significantly higher budget surplus in the mid-term period. European Commission calculations show that Slovenia ranks third in the EU in terms of the urgency of adjusting the budget balance to cover the costs of ageing. Estimates of the required adjustment given unchanged economic policies are very high (see Section 5). To achieve long-term sustainability, a mix of a suitably high target surplus and structural reform agenda will have to be applied. In any case, unless Slovenia wishes to tighten fiscal policy significantly beyond what EU calculations suggest, the entire potential budgetary burden of ageing will have to be neutralised with pension reform. Overall, the financing of debt that surged during the crisis, the challenge of funding the demographic transition and the pronounced risk of the crisis having a negative impact on sustainable economic growth, dictate that Slovenia must frame an expenditure fiscal rule with a target surplus of at least 1%.

## 8. Sale and management of state equity holdings in Slovenian companies as a possibility for consolidation of public finances and management of public debt

**State equity holdings in Slovenian companies can be used to buttress fiscal consolidation and debt reduction in two ways: through disposal of the property or by improving governance and increasing the annual income it generates.** The state has equity holdings in Slovenian companies either through Kapitalska družba (Pension Fund Management – KAD) or Slovenska odškodninska družba (Slovenian Compensation Company – SOD). After nearly 20 years, the Act on Corporate Governance of State Capital Investments<sup>61</sup> introduced a uniform and more transparent policy of managing these equity holdings. An agency for the management of state capital investments will manage equity holdings directly owned by the Republic of Slovenia, as well as strategic investments held by KAD and SOD<sup>62</sup> and the stake in insurance company Zavarovalnica Triglav currently held by the Institute for Pension and Disability Insurance. KAD and SOD holdings that will be managed by the agency include investments defined as strategic and holdings with a book value of over EUR 40 m. The agency's principal role is to manage these assets efficiently and transparently. Efficient management means two things: firstly, disposal of equity holdings that do not have the potential for long-term growth in value and profits, and secondly, efficient management of equity that is projected to remain in the ownership of the state. Companies that the government defines as strategic will be excluded from the agency's disposal policy.

**Only the disposal of equity holdings in direct state ownership can directly contribute to fiscal consolidation.** In discussing the scope for financial consolidation with disposal of equity holdings, it is important to understand that this can include only

<sup>61</sup> <http://www.dz-rs.si/index.php?id=101&vt=46&sm=k&q=zakon+o+upravljanju+kapitalskih&mandate=-1&unid=PZ|CB71CC36FA6801C4C12576BD002DFA00&showdoc=1>.

<sup>62</sup> [http://www.mf.gov.si/slov/mediji/2010/2010-04-15\\_3.htm](http://www.mf.gov.si/slov/mediji/2010/2010-04-15_3.htm).

holdings directly owned by the state,<sup>63</sup> not holdings within the portfolios of KAD<sup>64</sup> and SOD,<sup>65</sup> whose assets are explicitly intended to finance the public pension fund and cover liabilities stemming from the process of denationalisation.<sup>66</sup> Likewise with the privatisation of Zavarovalnica Triglav: the Republic of Slovenia does not directly own Triglav stock, the main shareholders are the Pension and Disability Insurance Institute (ZPIZ) and SOD.

**Companies in which the state has majority equity holdings can be classified as follows:**

a/ Companies performing public services that are likely to be ascribed a "broader importance": the official journal publisher Uradni list RS, the Slovenian Press Agency (STA), the Lipica stud farm, the CSS-IP company for the training and employment of disabled people, the Bodočnost company for the rehabilitation and employment of disabled people, the Fund for the Promotion of Development of the Triglav National Park, the air-traffic control operator Slovenia Control, the power operator Borzen, the power-distribution system operator SODO, the hotel and student housing Studentenheim Korotan. The book value of the state's equity holdings in these companies was EUR 267.9 m at the end of 2008.

b/ Energy companies: Elektro Slovenija, GEN Energija, Holding Slovenske elektrarne, INFRA izvajanje investicijske dejavnosti, Elektro Ljubljana, Elektro Gorenjska, Elektro Primorska, Elektro Celje, Elektro Maribor, Termoelektrarna toplarna Ljubljana. The book value of the state's equity holdings in these companies was EUR 2,317.2 m at the end of 2008.

c/ Transport and transport infrastructure companies: the DARS motorway company, the rail

operator Slovenske železnice, the telecommunications company Telekom Slovenije, the port operator Luka Koper, the airport operator Aerodrom Ljubljana. The book value of the state's equity holdings in these companies was EUR 796.8 m at the end of 2008.

d/ Mines in the process of closure: the Rudnik Trbovlje Hrastnik coal mine, the public company for the closure of the Rudnik Žirovski vrh uranium mine, the Rudnik živega srebra Idrinja mercury mine. The book value of the state's equity holdings in these companies was EUR 43.2 m at the end of 2008.

e/ Companies performing regular economic activity: the road-engineering company DDC, the Nafta Lendava refinery, the footwear maker Peko, the forestry company Snežnik. The book value of the state's equity holdings in these companies was EUR 59.2 m at the end of 2008.

f/ KAD, SOD, the DSU advisory and asset management company, SID banka and companies in the process of liquidation.

**Energy companies probably have the biggest potential for disposal and a positive contribution to fiscal consolidation. Realistically, however, the companies most likely to be sold are those performing regular economic activity and transport companies, but the value of the state's equity in the former is small and the latter are unattractive to potential buyers or classified as "strategic investments".** It may be assumed that companies performing public services with a "broader importance" will not be sold, there is unlikely to be interest in mines that are being closed and companies being liquidated, assets held by KAD and SOD cannot be directly used to reduce the deficit, the rights and powers of DSU are to be transferred to SOD, and SID is actually a development bank. Only energy companies have serious potential for sale, but this is unlikely considering the present political climate and public opinion in Slovenia. Objectively, however, there is no reason why the energy sector, with the exception of infrastructure (transmission network), should not be privatised, provided that the sector is reorganised and regulated to prevent monopolies and political interference. In this situation, then, the only potential candidates for sale are companies engaged in regular economic activity and transport or transport-infrastructure companies, i.e. DARS, Slovenske železnice, Telekom Slovenije, Luka Koper and Aerodrom Ljubljana. The book value of state equity holdings in companies performing regular economic activity was only EUR 59.2 m at the end of 2008. It is also questionable how attractive these companies are to potential investors. The value of equity holdings in transport and transport infrastructure companies is much higher, EUR 796.8 m, but they include companies unlikely

<sup>63</sup> For a full list of these shares see [www.mf.gov.si/slov/seajs/N\\_RS\\_v\\_GD\\_31\\_12\\_2009.pdf](http://www.mf.gov.si/slov/seajs/N_RS_v_GD_31_12_2009.pdf).

<sup>64</sup> For a list of KAD's holdings in companies, see [http://www.kapitalska-druzba.si/upravljanje\\_s\\_podjetji/nase\\_nalozbe](http://www.kapitalska-druzba.si/upravljanje_s_podjetji/nase_nalozbe).

<sup>65</sup> For a list of SOD's holdings in companies, see <http://www.sod-druzba.si/>.

<sup>66</sup> KAD and SOD debt also represents implicit public debt. When the state is the final guarantor for the payment of pensions and denationalisation bonds, financial liabilities may arise, but in principle this can happen only if KAD and SOD are unable to cover their liabilities. It is therefore possible that the state directly takes over KAD and SOD liabilities and their property becomes the property of the Republic of Slovenia. This solution had been planned, at least for the key KAD and SOD holdings (NKBM, Ljubljana, Telekom Slovenije, Petrol, Krka and Pozavarovalnica Sava), in the February 2010 version of the Bill Governing Conversion of Pension Fund Management (KAD), Transfer of Rights and Powers of D.S.U. to Slovenian Compensation Company (SOD), and Investment Policy of KAD and SOD ([www.vlada.si/fileadmin/.../si/.../Zakon\\_22.2.2010\\_zavarovalnica-1.pdf](http://www.vlada.si/fileadmin/.../si/.../Zakon_22.2.2010_zavarovalnica-1.pdf)), but the version of the bill that the government adopted on April 15, 2000 no longer includes this provision ([http://www.mf.gov.si/slov/mediji/2010/2010-04-15\\_3.htm](http://www.mf.gov.si/slov/mediji/2010/2010-04-15_3.htm)).

to attract much investor interest (DARS, Slovenske železnice) and "strategic" companies that are slated to remain in state ownership (Luka Koper, Aerodrom Ljubljana). All things considered, this leaves only Telekom Slovenije. Its estimated market value is about EUR 600 m (Simoneti et al., Razvojne priložnosti trga kapitala v Sloveniji po finančni krizi/Development opportunities of the capital market in Slovenia after the financial crisis), Institute for Economic Research, Ljubljana, 2010, p. 176), in which the Republic of Slovenia holds 52.54% of stock.

**Few companies in which the state has minority holdings are interesting for investors,**<sup>67</sup> the exceptions being the gas distributor Geoplin (32.6%),<sup>68</sup> the banks NKBM (41.5%)<sup>69</sup> and NLB (33.1%),<sup>70</sup> and the steel group Slovenska industrija jekla (25%).<sup>71</sup> The state could raise around EUR 390 m (based on the book value of shares) with its holding in NLB and about EUR 130 m (by market capitalisation) for NKBM. There are several companies in which the Republic of Slovenia has minority interest that are potentially interesting for investors, but the state's holdings in those companies are very small. These include Zavarovalnica Maribor, the pharmaceutical company Krka, the retailer Mercator, the Pivovarna Union brewery, the food company Perutnina Ptuj, the holding company Sava and the financial firm NFD.

**The goal of reducing the public debt by 2 p.p. of GDP through disposal of equity holdings is possible, but will be difficult to achieve politically and economically.** The Slovenian Exit Strategy 2010–2013 (2010, p. 11) states that disposal of the state's equity holdings could reduce public debt by about 2 p.p. or about EUR 850 m. The above data show that the Republic of Slovenia directly owns equity holdings worth substantially more than that, but the value drops drastically if companies with "broader importance", companies uninteresting for investors and companies denoted by the political system as "strategic" whether they really are or not, are excluded from the companies slated for disposal. EUR 850 m is therefore a feasible goal, but it is not necessarily easy to achieve in political terms (achieving political consensus on what amount of stock in "strategic" companies should be sold) and in economic terms (from the perspective of investor interest). Considering the size of Slovenia's public debt, the actual equity holdings of the Republic of Slovenia and the strong desire of the political players

to retain holdings in as many companies as possible, the disposal of these assets will not be able to make a significant contribution to debt reduction in our view.

**Decisions on the disposal of state equity holdings should consider the nature of the business and the strategic importance of the companies.** It would make sense to: (i) distinguish between companies that perform a public service or have a natural monopoly and companies that are no different than other market players; (ii) assess the growth potential of companies in which the state has significant equity holdings and withdraw from companies with poor growth prospects; (iii) preserve merely a controlling state (i.e. 26%) in companies deemed for any reason to be "strategic"; (iv) limit the state's role to that of portfolio investor in "non-strategic" companies (this being the least risky role) and undertake a gradual withdrawal; (v) reduce equity holdings of the state directly through capital injections by other investors or with the disposal of the state's holdings; (vi) undertake a gradual strategic privatisation through a public share offering in successive phases, for example selling a few percent every six months (Simoneti et al., 2010, p. 177).

**Another means by which state equity holdings in Slovenian companies can be used to buttress fiscal consolidation and deficit and debt reduction is by improving governance and thus increasing the annual income these assets generate.** Equity holdings held by the state directly or indirectly through KAD and SOD (their shares in "strategic" companies) will henceforth be managed by the agency. Management will thus be uniform, which in itself is a step forward. Income from equity holdings can potentially represent a permanent source of budget revenue, provided that the investments are managed efficiently – i.e. that the value of the equity holdings increases. The only way this can be achieved is if these companies develop. But the question is how the agency can contribute to development and increase the value of the investments. After 2004, in a period of rapid global economic growth, many Slovenian companies in majority ownership of the state and companies in which the state has a controlling stake have had significant trouble financing development owing to their weak capital base. As a key (majority or controlling) shareholder, the state has not been able to keep up with the demand for capital by providing sufficient capital increases. At the same time, through its controlling stake it actively prevented companies from raising capital on the market, so as not to jeopardise its majority or controlling stake. As a responsible shareholder, the state should have

<sup>67</sup> See [www.mf.gov.si/slov/seajs/N\\_RS\\_v\\_GD\\_31\\_12\\_2009.pdf](http://www.mf.gov.si/slov/seajs/N_RS_v_GD_31_12_2009.pdf).

<sup>68</sup> <http://www.geoplin.si/o-druzbi/organi-druzbe-in-lastniska-struktura>.

<sup>69</sup> <http://www.nkbm.si/content.aspx?docid=3343>.

<sup>70</sup> <http://www.nlb.si/delniski-kapital>.

<sup>71</sup> [http://www.sij.si/poslovanje/lastniski\\_delezi](http://www.sij.si/poslovanje/lastniski_delezi).

liberated these companies in terms of capital and development, which would have benefited the state as well as the companies. In companies designated politically as strategic, the state can allow capital injections by other shareholders until its holding drops to controlling-stake level (26%) without putting its influence at risk. In non-strategic companies, this limitation does not apply. That way the state would gradually increase the value of its holdings and, by extension, budget-revenue potential, even without selling its shares. This would improve the shareholder structure and corporate governance of state-owned companies, providing them with better shareholders and facilitating the inflow of fresh capital on financial markets (Simoneti et al., 2010, p. 177).

## 9. Consolidation of public finances and economic policy challenges

### 9. 1. Excessive-deficit procedure and Stability Programme – Update 2009<sup>72</sup>

***In December 2009, the European Commission launched an excessive-deficit procedure for Slovenia, setting 2013 as the deadline for correction of the deficit.*** In the April 2009 General Government Debt and Deficit Report, Slovenia estimated the deficit at 3.7% of GDP for the year but revised this figure to 5.9% in the second regular report in October 2009. In November 2009, the European Commission initiated, in line with the EC Treaty, an excessive-deficit procedure for Slovenia, which is detailed in the revised Stability and Growth Pact of 2005.<sup>73</sup> Based on an assessment of the state of public finances and factors that caused the excessive deficit, the EU drafted recommendations and set 2013 as the deadline for correction of the excessive deficit. The EC lists three key reasons why an excessive deficit occurred in Slovenia: (i) the economic slowdown and the resulting effect of automatic stabilisers; (ii) discretionary stimulus measures in line with the European Economic Recovery Plan (EERP) and tax-policy measures adopted before the onset of the crisis; (iii) strong dynamics of social transfers (especially from indexation arrangements) and compensation of employees (owing to the entry into force of the Public Sector Salary System Act and implementation of an agreement to address wage disparities). The EC, which in its 2009 autumn forecast projected an increase in Slovenia's deficit to 7% of GDP by 2011, also warned that the potential scope of fiscal policy is additionally limited owing to the challenges of the long-term sustainability of public finances and implicit liabilities

<sup>72</sup> Stability Programme – Update 2009. Ministry of Finance. January 2010.

<sup>73</sup> Article 104(3) of the EC Treaty stipulates that whenever a Member State's general government deficit exceeds the 3% of GDP reference value, the EC must prepare a report on the existence of an excessive deficit for the Council, which takes a decision on the matter. When the Council establishes that an excessive deficit does exist, it addresses the recommendations put forward by the EC to the affected Member State in accordance with Article 104(7) of the EC Treaty. The Council recommendation sets a deadline of no more than six months for the adoption of effective measures by the affected Member State. It also determines a deadline for bringing the situation to an end.

related to state guarantees. Based on assessment of fiscal and economic circumstances,<sup>74</sup> the EC set 2013 as the deadline for correction of the excessive deficit. It recommended that over the 2010–2013 period, Slovenia ensures an average annual structural budgetary adjustment of  $\frac{3}{4}$  p.p. of GDP and specifies measures necessary to correct the excessive deficit. The EC stressed that fiscal consolidation must ensure a permanent improvement of the public finances and their quality, and enhance potential GDP growth. In view of the higher-than-budgeted expenditure in the period 2006–2008 and the reliance on expenditure restraint in proposed 2010 and 2011 budgets, the EC highlighted that Slovenia needs to improve the enforceable nature of its multi-year budget plans and improve public-spending efficiency and effectiveness to make room for enhanced expenditure on research, innovation and development of human capital. In addition, the functioning of the labour market should be improved and the employment rate of young people and elderly people increased.

***The Stability Programme – Update 2009 of January 2010 layout measures to correct the excessive deficit in accordance with EC recommendations.*** It states that, given the slow economic recovery, revenue is not expected to return to its past trend over the medium term, having dropped substantially on the back of the decline in economic activity in 2009. Nevertheless, the government embarked on fiscal consolidation and correction of the excessive deficit with expenditure-side measures whilst planning to retain the revenue-to-GDP ratio at roughly the same level throughout the mid-term period. On the expenditure side, targeted and temporary measures taken to mitigate the impact of the crisis will be phased out starting this year; the first effects of consolidation are due to be visible in 2011. General government expenditure will be curbed and restructured, in particular through rationalisation and better management with development-oriented performance-based budgeting. A key element of fiscal consolidation expected to buttress economic recovery is maximising the drawing of EU funds for the financing of investments. The programme also includes wage- and employment-policy measures to limit the growth in compensation to employees, and measures to curb intermediate government consumption. Services provided by the state will be rationalised with a redefinition of standards for the

<sup>74</sup> This estimate includes all factors affecting the realisation of fiscal policy goals: general government debt and deficit at the start of the excessive-deficit procedure; indicators of external balance; implicit liabilities of the state associated with issued guarantees, in particular for measures to stabilise the financial sector during crisis; interest rates and yield spread on government bonds; mid-term changes in ageing-related general government expenditure.

#### **Box 8: EC opinion on the Stability Programme – Update 2009**

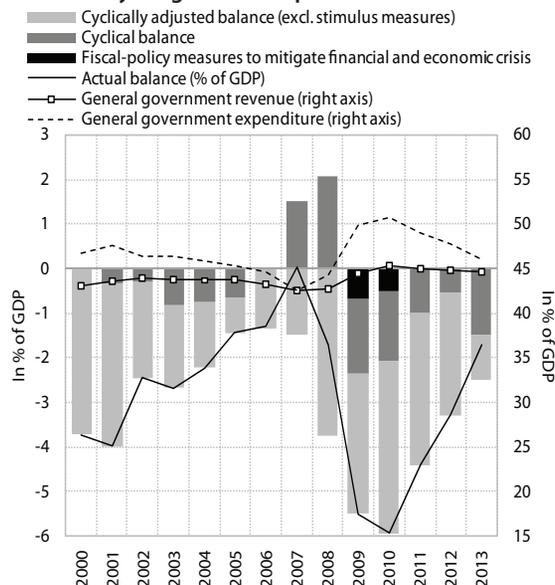
In its opinion on the Stability Programme, the EC states that the budgetary strategy for 2010 is broadly consistent with the Council recommendation under Article 126(7) of December 2, 2009. However, the budgetary outcomes could be worse than targeted in the programme and this possibility will increase over the programme period. For 2010, it estimates that the projected substantial growth in indirect taxes seems to be only partially substantiated by measures in the programme and on the high side given the subdued outlook for private consumption. Expenditure-growth outcomes have exceeded planned levels in recent years and this situation could reoccur. From 2011 onwards, there is a greater risk of expenditure overruns, according to the EC, as the underlying measures have not yet been fully specified or adopted, while some can be expected to be subject to the outcome of negotiations with the social partners. Furthermore, the size of the envisaged retrenchment should be set against the strong inherent expenditure dynamics and overruns witnessed in recent years, especially in the wage bill and social transfers (including pensions), both of which are planned to make a sizeable contribution to deficit reduction. The EC also recommends that the planned initiatives to enhance public-sector efficiency and rationalise the provision of public services and of social protection should be better harmonised. It warns that expenditure control should be enhanced, while implementation of multi-year budgets and the efficiency and effectiveness of expenditure should be improved. The EC associates revenue-side risks with the macroeconomic scenario beyond 2011, which it believes to be optimistic. Taking into account these risks, it believes the budgetary strategy may not be fully consistent with Council recommendations after 2011. The EC therefore states that broad consolidation measures need to be fully specified, adopted and implemented, but these also need to be sufficiently strengthened to address the risks from less favourable GDP growth and slippages on the expenditure or revenue side. Such a strengthening would also appear warranted in view of the high risks to long-term sustainability. Taking risks into account, the average fiscal effort over the period 2010–2013 may fall further short of the  $\frac{3}{4}$  p.p. of GDP recommended by the Council. The high risks to the long-term sustainability of public finances in Slovenia could be addressed, according to the EC, by setting a more ambitious medium-term objective, applying the new pension-indexation formula and implementing an already announced further pension reform aimed at curbing the substantial increase in ageing-related expenditure.

public sector (general public services), taking into account quality of service. Measures to rationalise the redistributive role of the state include the system of social transfers, pensions and health services, and in particular a change in the indexation rule for the adjustment of pensions to wages. The deficit is projected to drop to 1.6% of GDP by 2013 through an annual structural deficit adjustment of  $\frac{3}{4}$  p.p. of GDP until 2013, in line with the EU recommendations.

## 9. 2. Economic policy challenges in view of consolidation of public finances

**To achieve the Stability Programme objective of curbing the general government deficit to 1.6% of GDP by 2013, significant efforts are required to reduce the expenditure-to-GDP ratio.** The consolidation process laid out in the Stability Programme stipulates that the deficit will remain level in 2010 over the year before, whereupon it will be reduced by an average of EUR 450 m annually. This deficit cutting in nominal terms is underpinned by the projection that revenue growth will outpace expenditure growth in relative terms. Revenue is planned to match the projected economic recovery but, due to the specific tax elasticity, its growth will exceed GDP growth and revenue will rise as a share of GDP. Previous tax changes, the economic downturn in 2009 and the slow recovery have, however, since reduced the trend level of revenue compared with pre-crisis levels,

Figure 29: Consolidation of public finances according to the Stability Programme – Update 2009



Source: SORS, Stability Programme – Update 2009, IMAD estimate of cyclical components.

which means that economic-policy measures must significantly restrain nominal expenditure growth for consolidation to succeed. For 2010 and 2011, the Stability Programme stipulates a retrenchment of expenditure with a fiscal rule (nominally unchanged level of integral budget revenue), and in the years thereafter, spending will grow more slowly than revenue. In 2011–2013, expenditure as a share of GDP is projected to drop by 1.6 p.p. on average annually.

**In June, the government adopted a supplementary budget bill for 2010 that cuts spending and adjusts it to lower budget revenue.** The budget-revenue trend was fairly unfavourable at the beginning of this year, indicating that by the end of the year revenue would be lower than planned in the adopted budget. The government therefore intervened by adopting a supplementary budget adjusted to new estimates, which show revenue EUR 540 m lower than budgeted. The estimate is based on the latest, downgraded macroeconomic forecasts; however, the key change occurred in tax revenue, which is much lower than planned owing to significantly higher actual tax returns (in particular in corporate income tax) for last year. The supplementary budget matches lower revenue with cuts in expenditure to the tune of EUR 600 m (1.7% of GDP), but total expenditure is still about EUR 600 m higher than last year. The biggest adjustments compared to the adopted budget have been made in transport and transport infrastructure, health and defence. Smaller adjustments were made in current expenditure and transfers, where spending cuts were achieved primarily in goods and services. In the supplementary budget for 2010, Slovenia earmarked EUR 145m on the general-government lending and repayments account for loans to Greece as part of the EU's financial aid package for the indebted Member State.

**The proposed supplementary budget for 2010 merely aligns expenditure to lower-than-budgeted revenue and will not yet contribute to fiscal consolidation.** Spending cuts in the proposed supplementary budget are marginally higher than the drop in revenue, reducing the deficit by only EUR 58.6 m over the adopted budget. The proposal thus merely aligns expenditure to lower-than-budgeted revenue and will not contribute to fiscal consolidation this year. The structure of spending cuts shows that compared to the previously adopted budget for 2010, savings are being made mainly on investments that are being pushed forward into the following years. No major cuts are being made with systemic savings, a measure which is crucial for a more sustainable consolidation of public finances, and is already being enforced by several other European countries. Expenditure remains higher than last year. On the revenue side,

Table 13: State budget revenue, expenditure and balance

In EUR m	2007	2008	2009	Adopted budget 2010	Supplementary budget 2010 (June 2010)	Adopted budget 2011
Total state budget revenue	7,800	8,535	7,531	8,648	8,107	8,822
-% of GDP	22.6	23.0	21.6	24.8	23.2	24.3
Total state budget expenditure	7,763	8,470	9,260	10,474	9,874	10,376
-% of GDP	22.5	22.8	26.5	30.0	28.3	28.6
State budget balance	37	65	-1,729	-1,826	-1,768	-1,554
-% of GDP	0.1	0.2	-5.0	-5.2	-5.1	-4.3

Source: Ministry of Finance.

there is great reliance on EU funds, much as in the adopted budget, and higher excise revenue. But even coupled with much stronger non-tax revenue, excise cannot structurally plug the budget gap.

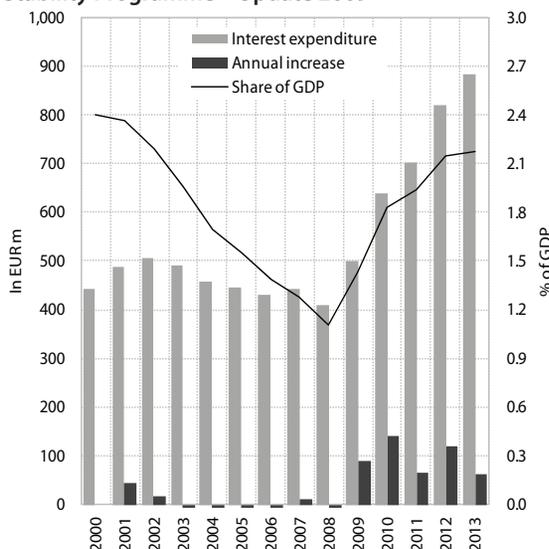
**The supplementary budget retains the 2010 deficit at the originally planned 5% of GDP, making the achievement of deficit reduction in the Stability Programme an even greater challenge for economic policy in the coming years, given the lower baseline revenue and expenditure.** The supplementary budget means that the expenditure-to-GDP ratio in 2010 will be below the level planned for 2011, when consolidation is set to begin according to the Stability Programme. Additionally, the deficit will not be cut this year. Reducing budget expenditure by 1.4 % of GDP, as planned for 2011, will therefore require massive expenditure cuts. With growing interest expenditure, expenditure other than interest payments will have to drop even faster than overall expenditure. Lower baseline revenue, which this year

is EUR 540 m or 1.6% of GDP below the level planned in the budget adopted in December 2009, will exert additional pressure on consolidation already in 2011.

**Consolidation must therefore start as soon as possible, and it must be conducted in a manner that ensures sustainability of the public finances in the medium and long term.** It is urgent because of the widening current deficit and the pressure on expenditure exerted by an ageing population, which will start to rise quickly in the coming years, as well as the relatively high scope of public guarantees, which are a potential liability and represent a risk that debt will increase rapidly if they are called up. Deficit-cutting measures need to start as soon as possible, in particular structural measures that will reduce the general government deficit in a sustainable way, i.e. preserve a stable structural fiscal position on a more sustainable basis.

**General government expenditure can be partially reduced with savings measures and rationalisation, but they provide insufficient scope for sustainable consolidation.** Judging by expenditure by function, consolidation can be buttressed by cutting spending on state-building functions (defence, public order and security, general public services) and culture, the latter having risen substantially since 2008 to above-average levels. In the 2009 budget and the 2010 supplementary budget, spending on state-building policies was cut; additional savings could be achieved only with consistent implementation of measures to improve the efficiency of the public sector and with rationalisation, as stipulated in the Stability Programme and Slovenian Exit Strategy 2010–2013. It is vital to implement the planned measures to reduce compensation to employees, which is projected to contract by 1.5% of GDP in the period 2010–2013 according to the Stability Programme. Based on available data, we estimate that the number of public-sector employees rose in the first quarter of this year, while the Stability Programme plans a 1% annual decrease until 2013. Achieving these objectives will

Figure 30: Interest expenditure according to the Stability Programme – Update 2009



Source: SORS, Stability Programme – Update 2009; calculations by IMAD.

therefore require additional efforts in the years ahead, in restriction of employment, where actual needs must be considered and the goal of maximising efficiency pursued, as well as in wage policy. Considerable savings can also be made by improving the efficiency of public procurement, which accounts for around 10% of GDP. However, these areas do not provide sufficient scope for permanent consolidation of public finances.

***A broader and consistent solution to reducing total expenditure as a share of GDP lies in restructuring expenditure with structural reforms geared towards strengthening the role of development expenditure earmarked for promoting competitiveness, and maintaining the long-term sustainability of public finances.***

It is vital to consistently implement programme-based budgeting and to exclude inefficient programmes, sub-programmes and measures of public financing from individual functions and policies. One option for preparing programmes, sub-programmes and measures, and measuring the efficiency of these, is to implement performance-based budgeting and eliminate the current methodological shortcomings to improve efficiency. Restructuring also makes it possible to reduce expenditure on otherwise efficient economic activities, by curbing and reforming spending on agriculture (which is above average in Slovenia) and scaling back state aid to troubled companies and old industries. Agriculture expenditure must restructure towards improving the competitiveness of the sector and its institutions. In entrepreneurship financing, measures are needed for better promotion of small enterprises as the most dynamic part of the economy, which should effect a change in the structure of the economy. It is necessary to draw up or upgrade measures to improve the efficiency of other competitiveness-boosting expenditure, in particular by: improving the efficiency of spending on research and development,<sup>75</sup> carrying out adjustments in the management of public institutions and public administration, and increasing investments in the railways. Some of these measures have already been included in the Stability Programme and Exit Strategy. Public investments vital to economic activity will have to be majority-financed with EU funds as stipulated by both government documents, and public-private partnership should be enhanced, but it must be transparent and properly supervised. In social protection, savings can be made by improving the efficiency of social policy and better tying social transfers to social status, which is also envisaged in the Exit Strategy. In the provision of individual public goods (education, health, social protection,

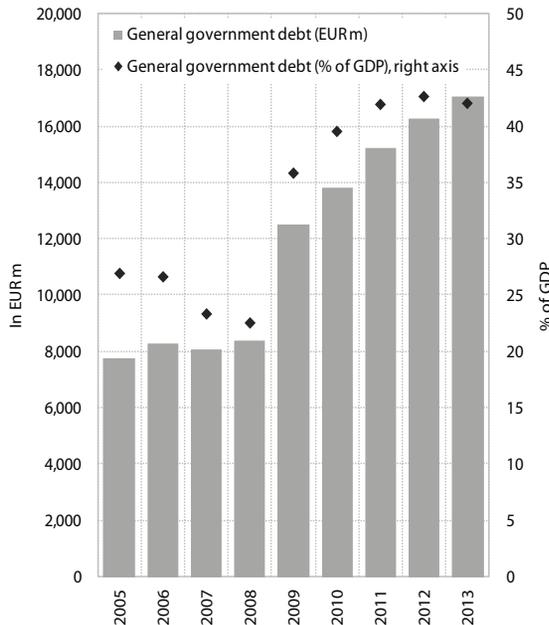
culture, sport) a part of the burden should be shifted from the state onto the private sector, which should be coupled with accelerated development of the services that Slovenia lacks, while always considering the current and future needs of the population. It is, however, necessary to bear in mind that the key factor determining the state of the public finances over the medium and long term is the changing demographic structure of the population. A more permanent consolidation of public finances and hence lower demand for borrowing can be achieved only with simultaneous structural adjustments in social protection systems. Pension reform, initially a change of the valorisation mechanism, followed in the shortest possible time by a comprehensive modernisation of the pension system, will slow down the growth in pension expenditure and postpone retirement. Additionally, pressure on expenditure growth will be alleviated by reform of health care and long-term care. All these reforms are already planned in both government documents, and it is now crucial that they be adopted as soon as possible and implemented in comprehensive fashion. Measures to raise non-tax revenue include institutional adjustments addressed by the Exit Strategy. The foundation of a Public Fund for the Management of Real Estate, for example, would increase revenue by facilitating the sale of unnecessary property, while at the same time reducing expenditure through professional management.

***Even though scope is limited, revenue can be raised with higher indirect taxes and expansion of the tax base.***

On the revenue side, the scope for increasing taxes is limited. Higher rates of taxes on labour and capital would have an adverse impact on economic activity and competitiveness, which, particularly in a period of slow and uncertain recovery, would have a dampening effect on the economy. In deciding on measures to increase revenue in these areas, it would make sense to consider solutions that would not place additional burdens on labour and capital. Tax-policy measures must focus on improving tax capacity by preserving tax rates and expanding the tax base with the elimination of present distortions (e.g. student work), simplifying tax procedures to encourage enterprises to register their business and thus reduce the scope of the grey economy, and improving the information system by introducing uniform records and ensuring better oversight. The introduction of a cap on the base for social-security contributions could also have a positive long-term impact on competitiveness and, by extension, revenue. In the short term, however, capping social-security contributions would reduce revenue, which would not be sustainable. The resulting revenue shortfall would therefore have to be offset with other

<sup>75</sup> See also Development Report 2010, IMAD.

Figure 31: General government debt according to the Stability Programme – Update 2009



Source: SORS (until 2009), Stability Programme – Update 2009 (forecasts 2010–2013); for GDP Spring Forecast of Economic Trends 2010; calculations by IMAD.

sources, primarily an expansion of the tax base. There is still scope to ensure more stable revenue through taxation of consumption. It would be advisable to make a transition towards raising indirect taxes, which are far less dependent on the business cycle, e.g. increasing VAT or excise rates. These measures must, however, be carried out with due consideration for their impact on inflation and, particularly for excise on fuels for transportation, for a potential drop in consumption. It therefore makes more sense to raise excise on products with relatively low elasticity of demand.

**Fiscal consolidation is essential if general government debt is to be stabilised at a sustainable level.** Assuming consolidation is implemented at the pace determined in the Stability Programme, debt growth will slow marginally in 2013 and the debt-to-GDP ratio could stabilise at just over 40% of GDP for a time. In 2010, general government debt will increase by a further EUR 1.3 bn according to the Stability Programme, reaching 39.6% of GDP.<sup>76</sup> By 2013, it will rise by another EUR 3.2 bn to EUR 17 bn or 42.1% of

GDP. Unlike in 2009, when the surge in nominal debt was also affected by front-loaded borrowing, debt growth in the coming years will be underpinned by the primary deficit, which is, however, expected to gradually drop and turn to surplus in 2013. Interest expenditure will increase from 2010 to 2013 by EUR 384 m, according to projections in the Stability Programme, swelling from 1.8% of GDP in 2009 to 2.2% in 2013. Nominal debt will rise in 2013, also due to the increase in debt-servicing expenditure, but the debt-to-GDP ratio will drop. The growing cost of debt servicing (growing share of interest expenditure) will exert additional pressure on reduction and restructuring of other expenditure in the process of consolidation. If consolidation proceeds more slowly than planned, debt will increase even faster. Implementation of additional debt-cutting measures in the form of disposal of state property (Slovenian Exit Strategy 2010–2013) can restrain debt growth only to a limited extent and for a short period (see Section 8), making consistent implementation of measures and structural reforms crucial for consolidation of the public finances and preservation of a sustainable debt level.<sup>77</sup>

<sup>76</sup> The share is higher than stated in the Stability Programme: it is calculated based on SORS data on general government debt in 2009 (which is higher than in the Stability Programme), projected nominal increase of debt under the Stability Programme and the GDP forecast from the Spring forecast of economic trends (IMAD, April 2010), which is lower than in the Stability Programme.

<sup>77</sup> Bovha Padilla and Padilla-Mayer (2010) estimate based on a variety of scenarios that there is significant probability Slovenia's general government debt will start rising very quickly already in the middle of this decade.

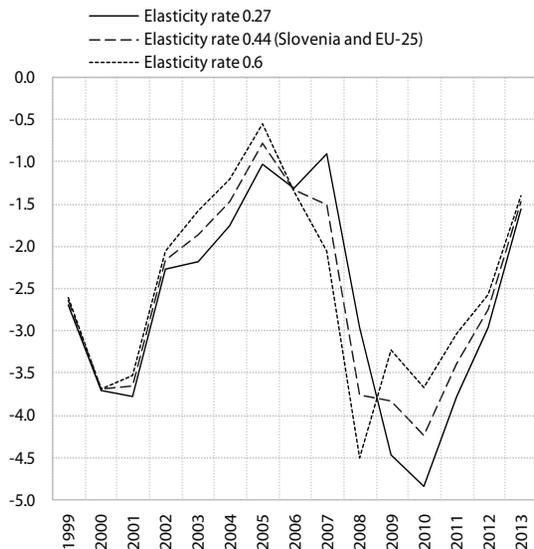
## APPENDIX 1

### Estimating the cyclically adjusted deficit

The cyclically adjusted deficit is calculated as the difference between the general government balance-to-GDP ratio and the product of the balance elasticity and output gap. The output gap is defined as the difference between actual and trend GDP expressed in percentages of trend GDP. It is estimated with the production-function method.<sup>78</sup> The figures below show the sensitivity of the cyclically adjusted balance to elasticity and the output gap, which are estimated values and therefore the biggest source of uncertainty in the calculation.

The balance elasticity for Slovenia is 0.44 according to EC estimates<sup>79</sup> and is calculated as the weighted sum of elasticity of individual components of the general government balance. The estimated elasticity for Slovenia is the same as the EU-25 average and 5 p.p. lower than the EU-15 average. Figure 32 shows the sensitivity of the cyclically adjusted balance to various rates of elasticity. We analysed changes in the cyclically adjusted balance for minimum and maximum elasticity estimates, i.e. for Latvia and

Figure 32: Sensitivity of cyclically adjusted balance to elasticity



Source: Ameco; calculations by IMAD.

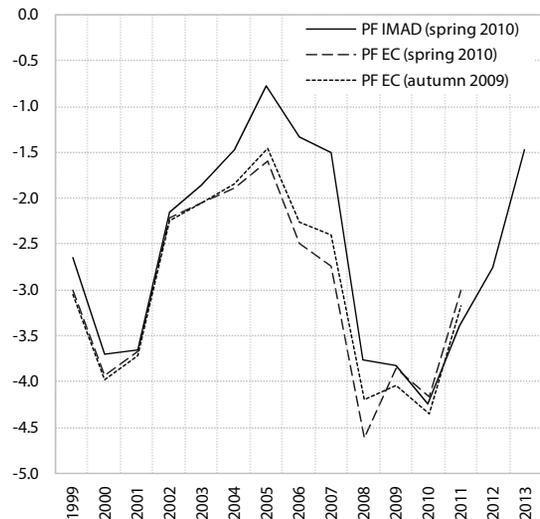
<sup>78</sup> The method is described in Jongen, IMAD working paper (3/2004). After the working paper was published, the methodology was slightly modified and upgraded.

<sup>79</sup> Ameco.

Denmark. Figure 32 indicates that differences are significant in particular in the period of high output gap, both in the positive and negative direction (2007–2013); in this case, the change in estimated elasticity has a relatively larger weight in the calculation of the cyclically adjusted balance. After 2010, the output gap should start to close and the cyclically adjusted balance to become less sensitive to elasticity.

Figure 33 shows the sensitivity of the cyclically adjusted balance to estimated output gaps. EC and IMAD output gap estimates differ due to differences in production functions and forecasts of GDP and components.<sup>80</sup> IMAD uses forecasts until 2015. The EC uses forecasts until 2011, and for subsequent years required for the HP filter used in the calculations, it uses the technical method of extension of data sets. Another factor behind differences in the period 2003–2008 is the degree of smoothing of data sets in calculations of potential-output growth. The Commission uses stronger smoothing, which leads to lower potential-GDP growth in 2003–2007 and consequently a higher output gap in 2003–2008.

Figure 33: Sensitivity of cyclically adjusted balance to output-gap estimates



Source: EC; calculations by IMAD.

<sup>80</sup> See Denis et al. (2006) for more on the Commission's methodology.

## APPENDIX 2

# General government expenditure by function

The table shows general government expenditure by function in 2008 for Slovenia, the EU-25 average and countries with the lowest and highest expenditure for individual functions.

Table 14: General government expenditure by function, EU, 2008, as % of GDP

<b>General public services</b>			<b>Housing and community amenities</b>	
Cyprus	9.8		Ireland	
EU-25	6.4		EU-25	2.4
<b>Slovenia</b>	<b>5.1</b>		<b>Slovenia</b>	<b>1.0</b>
Estonia	2.9		Greece	0.9
<b>Defence</b>			<b>Recreation, culture and religion</b>	
U. K.	2.5		Estonia	2.3
EU-25	1.5		<b>Slovenia</b>	<b>1.7</b>
<b>Slovenia</b>	<b>1.4</b>		EU-25	1.1
Luxembourg	0.3		Greece	0.4
<b>Public order and safety</b>			<b>Education</b>	
Estonia	2.7		Cyprus	7.8
EU-25	1.8		<b>Slovenia</b>	<b>6.2</b>
<b>Slovenia</b>	<b>5.1</b>		EU-25	4.9
Luxembourg	0.9		Greece	3.1
<b>Economic affairs</b>			<b>Health</b>	
Malta	7.4		Denmark	7.8
<b>Slovenia</b>	<b>5.1</b>		EU-25	6.8
EU-25	4.2		<b>Slovenia</b>	<b>6.1</b>
France	2.8		Greece	3.0
<b>Environmental protection</b>			<b>Social protection</b>	
Malta	1.6		Denmark	22.4
<b>Slovenia</b>	<b>5.1</b>		EU-25	18.3
EU-25	0.7		<b>Slovenia</b>	<b>15.9</b>
Finland	0.3		Latvia	9.4

Source: Ameco.

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# **Part II**

## **Labour market – consequences of the crisis and the government's response to the crisis**



## Summary

**The economic crisis affected the labour market in Slovenia and right across the EU.** In the EU as a whole, the unemployment rate increased by 1.9 p.p. to 9% in 2009. The employment rate (age group 15–64) in the EU decreased by 1.3 p.p., most of all for young people and those with lower levels of educational attainment. The unemployment rate in Slovenia according to the labour force survey increased by 1.5 p.p. in 2009, while the employment rate declined by 1.1 p.p. The number of people employed in the private sector fell by 8% in Slovenia between October 2008 and March 2010, while the number of registered unemployed people increased by 65.9% from September 2008 (when it was lowest) to May 2010. Growth in registered unemployment eased in the last five months, but restoring employment growth and reducing unemployment nevertheless remain two of the most important challenges to economic policy, in our estimation.

**Age segmentation on the labour market is still a problem in Slovenia.** The prevalence of temporary employment otherwise declined in 2009, as, with the onset of the crisis, enterprises first reduced employment by not extending contracts for fixed-term employment, a type of employment which is particularly frequent among the young (15–24 years). Although the proportion of temporary jobs among young people declined in Slovenia in 2009, it is still much larger than in other age groups in Slovenia and among the largest in the EU.

**Wage growth in the private sector has picked up in 2010, after declining in 2009, while wage growth in the public sector is easing, following a significant increase (due to the new wage system).** Growth in the private-sector gross wage slowed significantly in 2009 with the impact of shrinking economic activity, particularly due to lower overtime payments. At the same time, it was also marked by significant changes in the structure of employment and unexpectedly high extraordinary year-end payments in certain sectors; in 2010, it is strengthening again. Public-sector wages increased significantly in 2008 and 2009 as a result of the first two phases of the elimination of wage disparities, but, in the second half of 2009, their growth started to slow as a result of government measures.

**The implementation of wage reform in the public sector coincided with the economic crisis, which required intervention by the government. The completion of the wage reform programme remains a challenge.** The Public Sector Salary System Act was adopted in 2002, but preparations for its implementation took place until mid-2008. As the implementation coincided with the beginning of the economic crisis, new agreements had to be reached between social partners on wage policy in the public sector, which delayed dealing with the problem of disparities between public- and private-sector wage growth to the following years. Wage reform in the public sector was intended to change internal wage ratios in the public sector. However, the first two wage adjustments towards the elimination of disparities also brought about a significant change in the ratio of public- to private-sector wages, which was not the purpose of the reform. In 2009, this ratio thus exceeded the ratio from 2000 (before the reform), and is also set to increase significantly in the coming years, according to our estimates. The ratio of the public- to private-sector gross wage in Slovenia had already been high in 2006, compared with other countries, according to Eurostat's data. As another two quarters of the elimination of wage disparities in the public sector are foreseen, wage policy is faced with the challenge of how to carry out the reform without impairing relationships between the public and private sectors. Growth in public-sector wages and employment also widened the general government deficit in 2009. With the need for public services growing, due to demographic and other reasons, it will be necessary to provide systemic solutions to ensure creation of jobs in this area, which will not be funded from public sources alone.

**Active employment policy will need to pay special attention to the number and share of long-term unemployed people and the unemployment rate of young people, all of which are rising again.** After declining in the first half of 2009 due to the high inflow of newly unemployed people, the share of long-term unemployed people in the total number of the registered unemployed resumed growth towards the end of the year, which calls for attention and active employment policy measures. Given that long-term unemployment reduces an individual's opportunities to find a new job, it is necessary to devise and expand programmes preventing transition into long-term unemployment and increase the participation of long-term unemployed persons in active employment-policy schemes. In 2009, the unemployment rate of young people (15–24 years) increased much more than the average unemployment rate. Special attention should therefore also be devoted to this group of the unemployed, within the scope of labour-market, as well as educational, policies.

**The government responded to the deteriorating labour-market situation** by passing, in 2009, two emergency acts to preserve jobs (the Partial Subsidising of Full-Time Work Act and the Partial Reimbursement of Payment Compensation Act). Funding allocated to the implementation of active employment-policy (AEP) schemes increased to 0.5% of GDP, after hovering between 0.21% and 0.39% of GDP for a number of years.

**The volume of funds for the implementation of active employment-policy programmes increased during the economic crisis, but the programmes need evaluation.** The number of people participating in AEP programmes rose significantly in 2009, though not for all groups of the unemployed. The participation *rate* (measured as the ratio of the number of participants in a certain group of unemployed people to the total number of unemployed people in the same group) grew most notably for women, while the increase in the participation of long-term unemployed people and those older than 50 was very modest, which heightens the risk of unemployment persisting in the years to come. Growth in the number of financial social-assistance beneficiaries participating in the schemes is relatively modest, which is unacceptable from the perspective of social inclusion. Along with the implementation of measures, it would be necessary to provide for continuous assessment, comprehensive monitoring and independent evaluation of their effects.

**The time of crisis also calls for changes in the system providing income security to the unemployed, which in Slovenia have yet to be made.** As Slovenia has not yet changed the unemployment-insurance system in the current crisis, the weaknesses of the system have become all the more visible. The share of unemployed young people (aged 15–29) receiving unemployment benefits increased only temporarily in 2009 and is still relatively low, as a result of the relatively short period of entitlement to unemployment benefits and strict eligibility criteria for the young. It would be necessary to improve the legislation governing unemployment benefits so as to provide income security for the unemployed during the current crisis and thus to support the concept of flexicurity. This will be partly addressed by changes brought about by the new draft Labour-Market Regulation Act, but we estimate that these changes will nevertheless come too late to provide income security for the unemployed in the present crisis.

**It was mainly enterprises from the manufacturing sector that availed themselves of job-preservation schemes.** Enterprises have shown great interest in both emergency acts aimed at preserving jobs ever since their adoption; however, towards the end of 2009, their interest began to fade due to the gradual recovery of economic activity in manufacturing, where these schemes were most extensively used. According to ESS data on payments, around 4,800 wage compensations, on average, were reimbursed per month (0.6% of employed people), and around 32,000 subsidies for full-time work paid (4.2% of employed people). In the manufacturing sector, the manufacture of metals and the manufacture of electrical appliances recorded the largest shares of employees participating in the two schemes. As the Partial Subsidising of Full-Time Work Act does not tie the allocation of subsidies to difficulties related to the crisis, subsidies were also granted to a number of enterprises from sectors where difficulties may not have been entirely due to the crisis. A particularly large share of enterprises taking part in the schemes has also been observed in transport and storage activities, due to the participation of employees of Slovenske železnice, which also received various subsidies in previous years, and where difficulties worsened further in 2009.

**The economic crisis has not been sufficiently used for developing the skills of workers on temporary layoff.** The Partial Reimbursement of Payment Compensation Act obliges employers to provide education and training for workers on temporary layoff that is subsidised by the government. The extent to which “non-working” time was used for training and education was nevertheless modest. Furthermore, the contents of training programmes are questionable and may not contribute to an individual's employability, given that enterprises mainly offered internal training carried out only by in-house mentors. As already pointed out in Economic Issues 2009, leaving the responsibility for education and training of employees entirely to the employer (without appropriate support by expert institutions) may not be the best solution in terms of using the crisis as an opportunity to develop new skills relevant for the labour market.

## Introduction

***The economic crisis has a significant impact on the labour market, which is an important mechanism of economic adjustment to possible shocks.*** The labour market may react to a shock by (i) labour-cost flexibility; (ii) labour mobility, including geographical and intersectoral mobility; and by (iii) adjusting the quantity of work through changes in the number of employees or the number of hours worked. The decline of economic activity in 2009 thus had an impact on employment, unemployment and unit labour costs in the majority of EU countries. In 2009, the unemployment rate in the EU increased to 9%, up 1.9 p.p. from 2008, while the employment rate (age groups 15–64) dropped by 1.3 p.p. According to the OECD, real-wage flexibility could speed up labour-market adjustment, which may depend on the institutional mechanism of wage determination in a country and on the situation on the labour market. As to the actual movements of real hourly earnings across OECD countries in 2009, countries can be divided into three groups, according to OECD experts: i) Sweden, Denmark, United Kingdom, Australia and Slovakia belong in the first group, where, with higher unemployment, real hourly earnings declined, ii) the US, Canada and Spain saw average hourly earnings increase due to an above-average decline in low-skilled and low-paid employment, while (iii) in Japan and numerous European countries,<sup>1</sup> real hourly earnings increased despite the recession (OECD, 2010).

***During the present crisis, governments have adopted numerous additional labour-market policy measures.*** Most of the EU countries boosted the implementation of labour-market policy measures in 2009 and earmarked more funds for this purpose. In 2009, a number of countries adopted i) strategies to increase demand for labour, particularly measures facilitating a temporary reduction in working hours during the time of crisis, ii) measures for re-employment and training with so-called "early action"<sup>2</sup> and promotion of entrepreneurship and development of work experience, and iii) income support for unemployed people and those receiving low wages.

***The paper analyses labour-market developments during the economic crisis and the labour-market policy set out by the Slovenian government in response to the crisis.*** The analysis is presented in three sections. The first analyses the impact of the economic crisis and anti-crisis measures of labour-market policies in the EU. The second provides a detailed overview of labour-market developments in Slovenia during the economic crisis, highlighting the key issues relating to wage policy in the public sector. The third section presents a detailed analysis of anti-crisis measures on the Slovenian labour market, showing the response of active labour-market policy, the implementation of which was boosted in 2009, and the effects of passive labour-market policy measures, where no systemic change has yet been made in Slovenia during the current crisis. We further analyse the implementation of intervention acts put in place to preserve jobs. The concluding fourth chapter aims at highlighting the key challenges and problems relating to the labour market in Slovenia.

<sup>1</sup> Ireland, Poland, Finland, Austria, Belgium, Italy and the Netherlands.

<sup>2</sup> A number of countries have introduced additional measures (the so-called "early action") and increased the responsibility of job seekers, while offering unemployed people assistance in finding new jobs immediately after they have become unemployed or even before they have actually lost their jobs.

# 1. Trends in the labour market and anti-crisis measures in the EU

## *The global economic and financial crisis was also reflected in a deterioration in the EU labour market.*

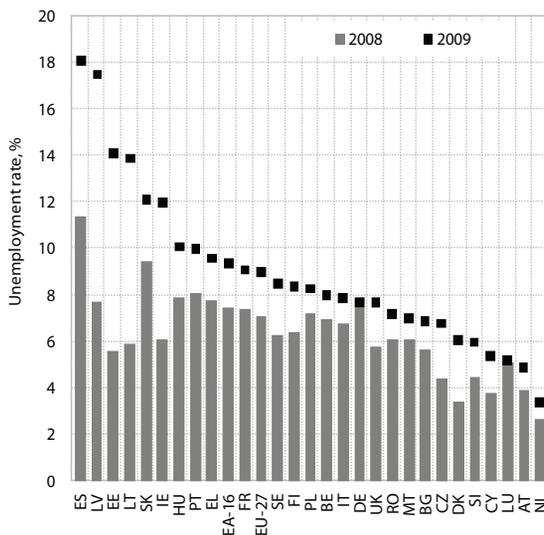
After the deepening of the economic crisis in the EU in mid-2008, a major adjustment took place in the EU labour market in the first quarter of 2009. After reaching the lowest level in March 2008 (EU 6.8%, EA 7.2%), unemployment increased by 1.4 p.p. in the period between January and December 2009, amounting to 9.4% in December 2009 (EA 9.9%). According to Eurostat, about six million people have lost jobs since the onset of the crisis; those hit hardest include workers with no work experience, low-skilled workers,<sup>3</sup> and, in particular, men, as the crisis mostly affected the construction and industry sectors. In 2009, the employment rate dropped by 1.3 p.p., and recorded an annual average of 64.6% (EA 64.7%). The situation in the labour market deteriorated most notably in those countries that were most severely affected by the crisis (Spain, Ireland and the Baltic states). Compared with the fourth quarter of 2008, employment dropped in almost all EU countries in the fourth quarter of 2009. Among Slovenia's main trading partners, a stronger drop in employment was

posted in Spain (-6%), Italy (-1.8%) and in the United Kingdom (-1.7%), while in Germany, employment declined by a mere 0.4% in the same period. The long-term unemployment rate in the EU also increased in 2009, for the first time in three years.<sup>4</sup> The largest increase in the long-term unemployment rate was recorded in Spain (+2.1 p.p. in 2009), which also had the highest unemployment rate in the EU in 2009 (18%), as shown in Figure 1.

## *The economic crisis mainly affected the employment prospects of the male population and of the young.*

Due to declining economic activity, the average employment rate in the EU dropped by 1.3 p.p. (to 64.6%) in 2009. The employment rate of women dropped by 0.5 p.p. to 58.6%, and of men, by 2.1 p.p. to 70.7%, which can be attributed to the fact that the first year of the crisis hit hardest the sectors that mainly employ men. The gender gap in the employment rate therefore decreased, yet the female employment rate is still about 12 p.p. behind the male employment rate. The effect of the crisis varied from age group to age group: In the 25–54 age group, the share of persons in employment was 78.2% (a 1.4 p.p. drop over the year before), the employment rate of older people (55–64 years) was 46.0%, a 0.4 p.p. increase over the year before, while the highest fall was observed in young people (15–24 years), of 2.4 p.p. (to 35.2%). This reduction in employment of the young can mainly be attributed to the fact that young people start their working lives mostly in temporary employment, which was the first area to be cut during

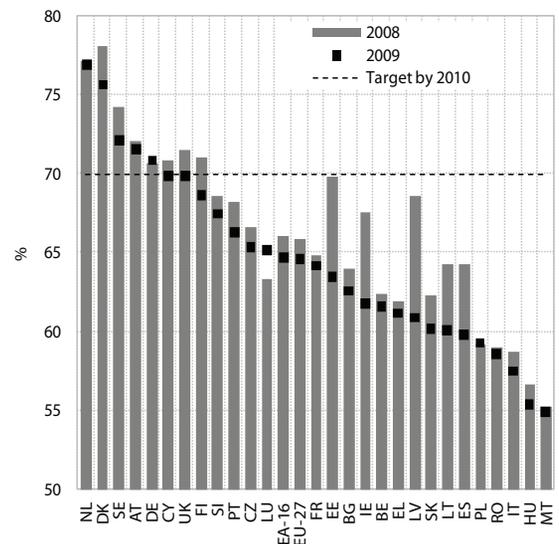
Figure 1: Unemployment rates in EU Member States, 2008–2009



Source: Eurostat Portal Page – Labour Market, 2010.

<sup>3</sup> Compared to 2008, the unemployment rate in the low-skilled population increased by 3.2 p.p., in the population with secondary and higher education by 1.9 p.p., and in those with tertiary education by 1.2 p.p.

Figure 2: Employment rates in the EU countries in 2008–2009, in %



Source: Eurostat Portal Page – Labour Market, 2010.

<sup>4</sup> In the EU, the unemployment rate rose by an average of 0.4 p.p. in 2009 compared with the year before, and amounted to 3%.

the economic crisis. Unemployment of people under 25 increased much more in 2009 than in other age groups, by 4.2 p.p. to 19.6%. The position of the young in the labour market thus further deteriorated in the crisis. Figure 2 shows that most countries saw a drop in the employment rate in 2009, and the EU moved away from the Lisbon target, set in 2000, of achieving 70% employment by 2010.

**Most EU countries recorded an increase in the prevalence of part-time and temporary employment in 2009.**<sup>5</sup> The two indicators show reduced labour demand on the part of the enterprises, as the prevalence of part-time employment increased by 0.6 p.p. from 2008 to 18.8% in 2009, while the prevalence of temporary employment dropped by 0.5 p.p. to 13.5%. The highest increase in the share of part-time employment was recorded in the countries that were most severely affected by the crisis (Ireland and the Baltic states); it should be noted, however, that the prevalence of part-time employment in these countries rose mainly due to labour-market flexibility, and not as a result of temporary anti-crisis measures. The share of temporary employment primarily diminished in those EU countries (Spain, France, Italy), where the share of temporary employment in total employment had already been high before the crisis, since during the crisis, enterprises in these countries frequently downsized through non-extension of fixed-term employment contracts.

**In 2009, the EU Member States adopted a series of measures to alleviate the effects of the crisis in the labour market.** The measures selected had to focus on target groups and were intended to produce an immediate effect in the labour market, while remaining compatible with long-term objectives. The EU countries implemented several, mostly temporary, measures in the labour market, accounting for about 0.4% of EU GDP in 2009, but coverage is expected to fall to 0.2% of EU GDP in 2010. More than half the amount spent on measures implemented in the labour market was intended to promote the purchasing power of households and increase work incentives through optimisation of the tax system. These measures were largely successful in mitigating the consequences in the labour market in most EU Member States. Very few temporary measures were introduced in the labour market in the Baltic countries and Ireland, where unemployment rose the most, largely due to lower activity in the construction sector. Temporary measures that may potentially have a significant negative impact on the economy are being gradually replaced by permanent measures, which are expected to account for approximately

0.6% of EU GDP this year. The permanent measures implemented in 2010 are mostly aimed at changing the tax system and promoting the purchasing power of households; measures expanding the scope of education and training programmes, and improving access to these, are also expected to have a long-term effect.

**Temporary anti-crisis measures in the labour market include measures for subsidising shorter working time, strengthening active employment-policy programmes, and improving access to unemployment benefits.** Most of these measures were expected to end by the close of 2009, but many have been extended until the end of this year due to the tightening situation in the labour market. Many countries decided to subsidise shorter working time (the Netherlands, Slovenia, Slovakia, the Czech Republic, Austria, Germany, Italy, Belgium, Luxembourg), a measure that should help in preserving jobs. While implementing this measure, some countries have promoted and also frequently subsidised additional training of part-time employees. According to preliminary estimates by EU Member States, these measures helped to preserve, at least temporarily, more than 500,000 jobs, of which 350,000 were in Germany.

During the crisis, countries also reinforced their active labour-market policies, which include education and training programmes for the unemployed and employed, programmes for boosting employment and creating new jobs, and programmes offering job-search assistance. Several countries created new education and training programmes or expanded existing programmes, while also improving accessibility of education and training. Austria, Denmark, Finland and the Netherlands prepared special assistance programmes for employment promotion, intended for the young. The Netherlands, for example, earmarked around EUR 220 m for this purpose in 2009 and 2010. The bulk of this money is dedicated to promoting employment opportunities for young people through extending participation in training programmes and by increasing the duration of training for young people completing their studies in vocational schools.

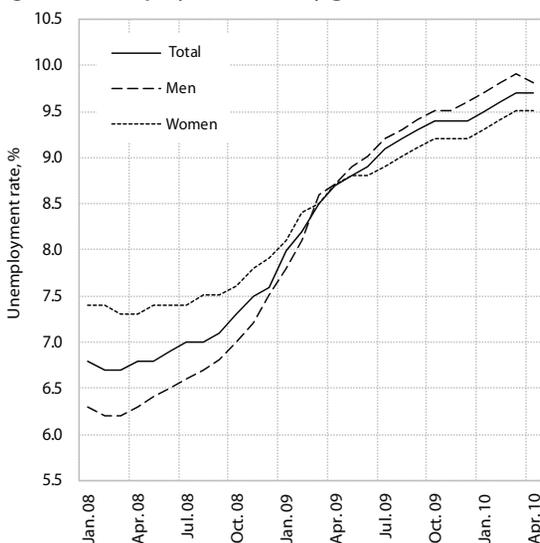
To enhance the income security of the unemployed, some countries have introduced changes in unemployment benefits, extending entitlement to benefits or mitigating the eligibility criteria (Bulgaria, Denmark, Spain, Italy, Romania). Last year, unemployment benefits increased in Belgium, Greece, Italy and the United Kingdom (under certain conditions, either as an increase in unemployment

<sup>5</sup> The incidence is measured by means of the share of temporary and part-time employment in total employment.

benefit for a certain period of time, or as a one-off payment).

**Although unemployment growth slowed at the beginning of 2010, the situation is expected to deteriorate further.** With slower unemployment growth, the first quarter of the year saw the first signs of labour-market stabilisation. In the first four months of 2010, the unemployment rate in the EU rose by 0.2 p.p. to 9.7% (EA 10.1%). Over the past four months, Germany, Malta, Slovakia, Denmark and Hungary recorded a slight drop in the unemployment rate. This can be attributed to the recovery of global trade, increased economic activity in the EU, and short-term anti-crisis measures, which, along with some previously implemented structural reforms, helped to mitigate the negative impact of the crisis in some countries within the EU. Nevertheless, the still relatively limited adjustments in the labour market, along with intersectoral mobility due to the crisis, indicate that recovery within the EU in this and in the following year will take place without any significant employment growth and with a potentially high and persistent unemployment rate. According to spring forecasts by the European Commission, employment in the EU will drop by a further 1% or so, while the unemployment rate will remain close to 10% (EC, 2010a). As the extent of the crisis varies across the EU, the differences in the unemployment rate have increased further since the onset of the crisis, meaning that the speed and duration of the labour-market recovery will also vary from country to country.

Figure 3: Unemployment rate, by gender, EU



Source: Eurostat.

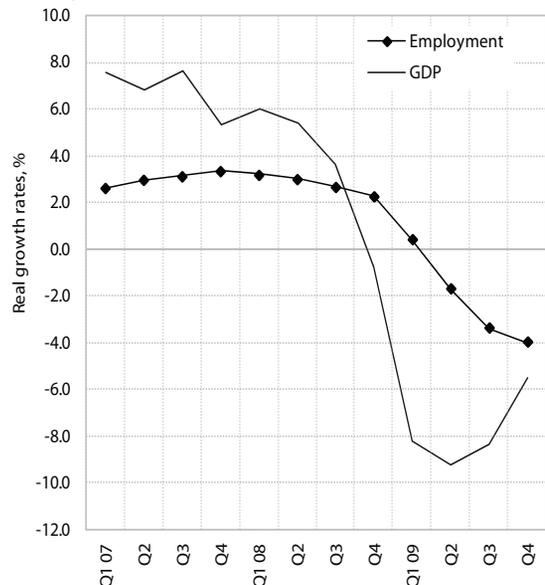
## 2. Labour-market trends in Slovenia

**The economic crisis brought about several changes in the Slovenian labour market.** In November 2008, employment started to decrease in the private sector, falling by 8% in the period between November 2008 and March 2010. In the period from September 2008, when registered unemployment was lowest (59,303), until the end of 2009, it grew to around 100,000, a level maintained in the first months of 2010. The private sector responded to the crisis by reducing overtime work, shortening working hours, and slowing wage growth. Conversely, the public sector witnessed acceleration in wage rises in 2009 due to the elimination of wage disparities, while employment continued to increase. A detailed description of these labour-market trends is provided in the following sections.

### 2.1. Employment according to the Statistical Register of Employment

**Following strong growth in 2007 and in the first three quarters of 2008, the number of people in employment according to the Statistical Register of Employment started to decline in November**

Figure 4: Year-on-year growth rates in GDP and employment, Slovenia, in %



Source: SORS, calculations by IMAD.

Table 1: Changes in the number of persons in formal employment by activity, 2008–2010

	Y-o-y growth rates, %			Change in number				
	2008/ 2007	2009/ 2008	Q1 10/ Q1 09	Q1 09/ Q4 08	Q2 09/ Q1 09	Q3 09/ Q2 09	Q4 09/ Q3 09	Q1 10/ Q4 09
PERSONS IN FORMAL EMPLOYMENT - total	3.0	-2.4	-3.8	-16090	-7963	-6752	-5920	-12024
Private sector (A–N, S – T)	-3.9	-3.5	-5.2	-17129	-9318	-6070	-7386	-13407
Public sector (O–R)	2.2	2.0	2.0	1039	1355	-681	1466	1383
A Agriculture, forestry and fishing	-1.8	-4.5	-15.6	-1064	199	-72	-95	-5931
B Mining and quarrying	-5.2	-7.5	-11.2	-72	-44	-48	-131	-158
C Manufacturing	-0.5	-10.1	-9.3	-9665	-8113	-4617	-5003	-1774
D Electricity, gas, steam and air conditioning supply	-1.1	2.9	2.6	66	104	29	65	7
E Water supply sewerage, waste management and remediation activities	4.7	2.3	1.9	-68	175	54	-59	-3
F Construction	12.2	-1.3	-7.9	-3234	-206	-737	-2073	-3914
G Wholesale and retail trade, repair of motor vehicles and motorcycles	3.5	-1.0	-2.7	-1045	-1190	-763	-299	-884
H Transportation and storage	5.4	-2.8	-4.7	-929	-745	-584	-350	-704
I Accommodation and food service activities	1.7	0.6	-0.9	-418	306	9	-299	-307
J Information and communication	4.8	2.8	-0.1	110	91	-120	38	-35
K Financial and insurance activities	4.2	1.0	-2.5	100	-38	-312	-204	-54
L Real estate activities	9.6	4.7	0.2	12	69	-5	-48	-9
M Professional, scientific and technical activities	7.1	4.6	3.9	64	56	668	706	317
N Administrative and support service activities	5.2	-1.7	2.1	-943	-175	284	379	36
O Public administration and defence, compulsory social security	1.3	1.1	1.2	156	388	198	-86	129
P Education	1.5	2.8	3.0	490	329	-709	1505	718
Q Human health and social work activities	2.7	2.1	1.6	344	548	-130	-30	427
R Arts, entertainment and recreation	6.5	1.8	1.7	48	89	-41	77	109
S Other service activities	1.3	3.7	2.5	-29	146	142	17	22

Source: SORS, calculations by IMAD.

**2008, while in the first quarter of 2010 this trend slowed.** Slovenia thus had 836,900 people in formal employment<sup>6</sup> in March 2010 (3.4% less than in the year before, and 5.8% below the level in October 2008, when this number was the highest since 1990). The contraction of employment (by as much as 4.1% y-o-y in the last quarter of 2009 and by 3.8% in the first quarter of 2010) was related to the economic recession, which began in the last quarter of 2008 and continued into 2009, before easing this year. As shown in Figure 4, the fall in employment was slower and milder than the decline in economic activity.

**The largest fall was recorded for the number of persons in employment, whereas the number of self-employed persons in non-agricultural sectors rose despite the crisis.** In the period between October 2008, when it was highest, and March 2010, the number of employed persons dropped by 51,000 (-5.8%); the number of farmers also fell (by

6,798 or 20.5%<sup>7</sup>), while the number of self-employed persons in non-agricultural sectors has been steadily growing for several years, as a result of large enterprises outsourcing certain work and services to the small-business sector, and owing to intensified implementation of programmes promoting self-employment under the active employment policy in 2009.

**In 2009, the number of persons in employment dropped in the private sector (most notably in manufacturing and construction), but increased in the public sector.** In manufacturing, the decline started as early as the second quarter of 2008. In the period between October 2008 and March 2010, the number of persons in employment fell by more than 31,000 (-14.5%), most notably in manufacture of metal products and clothing, while it rose only in manufacture

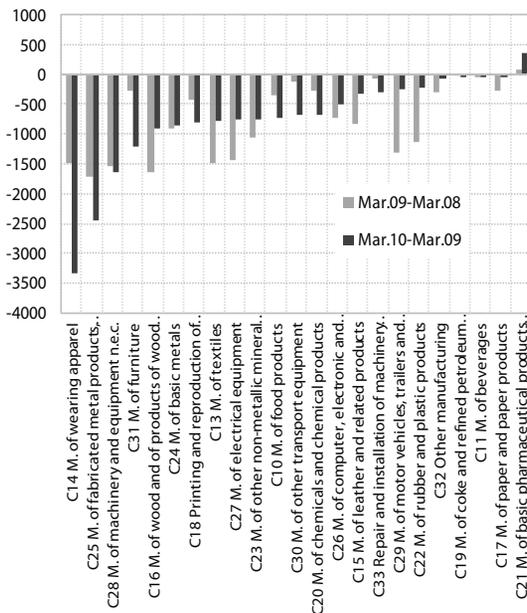
<sup>6</sup> Employed and self-employed persons according to the Statistical Employment Register, including self-employed farmers.

<sup>7</sup> SORS estimates the number of farmers based on data from the Labour Force Survey for the previous quarter. In the period between December 2009 and January 2010 alone, the number of farmers is thus estimated to have dropped by 5,781 (17.9%); this a statistical estimate rather than a recorded reduction.

of pharmaceutical raw materials and preparations (see Figure 5). Construction was another sector to see employment fall, owing to lower construction investment. The number of persons employed in the construction sector started to decrease in November 2008, falling by more than 11,000 (-12.9%) by March 2010. Other major sectors hit by falling employment included agriculture, wholesale and retail trade and transport. In most other services, the number of persons in employment rose in that period. In the private sector, the greatest increase was recorded in professional, scientific and technical activities, while in the public sector, employment rose most in education, health and social care (see Table 1).

**Employment would have dropped even more significantly, particularly in manufacturing, had the government not adopted several labour-market interventions in 2009.** To mitigate high unemployment and to help enterprises avoid costs related to layoffs as a result of a decline in orders and lower demand, the government adopted two emergency acts,<sup>8</sup> which included more than 80,000 employed persons in subsidy schemes (for more detail, see Chapter 3.3) and thereby prevented even faster growth in unemployment. The drop in

Figure 5: Changes in number of people in employment by manufacturing-industry group in Slovenia, March 2008–March 2010



Source: SORS.

<sup>8</sup> The Partial Subsidising of Full-Time Work Act, OG of RS 5/2009, and the Partial Reimbursement of Payment Compensation Act, OG of RS 42/2009.

the number of persons in employment was further buffered by extensive active employment policy measures. In 2009, about 13,000 unemployed persons found work within programmes of employment, self-employment and public works (over a quarter of all the unemployed who found work in 2009, or 15% of the average number of registered unemployed persons in 2009). The year before, this share was about 50% lower. In the first quarter of 2010, the implementation of programmes was equally or even more intense (for more detail, see Chapter 3.1).

**The number of foreign employees in Slovenia is also falling.** In 2007 and in the first three quarters of 2008, the number of persons in employment rose mainly through increased recruitment of foreign workers. As a result of employment cuts in the time of recession, the number of foreign workers in Slovenia also started to fall. According to the Statistical Register of Employment, the number of foreign workers in Slovenia increased to 70,327 by September 2008 and has been decreasing ever since, totalling 60,157 in March 2010.<sup>9</sup> Almost half work in the construction sector. Other sectors employing foreign workers are manufacturing, transport, wholesale and retail trade, accommodation and food service activities, professional, scientific and technical activities, and administrative and support service activities.<sup>10</sup> In the past 12 months, the number of foreign workers dropped in all of the above-mentioned sectors, with the highest fall recorded in construction.<sup>11</sup>

<sup>9</sup> The number of valid work permits for foreigners issued by the Employment Service of Slovenia is considerably higher. It continued to rise until March 2009 (totalling 92,642), when it started to fall, reaching 76,473 by March 2010. The gap between the two figures is due to several reasons. Specifically, a work permit issued by the Employment Service of Slovenia, is a condition for a foreigner to obtain a residence permit, which in turn is a prerequisite for concluding an employment contract; based on the experience of the Employment Service of Slovenia, there may therefore be a lapse of two to three months between the issuance of the work permit and the actual hiring. Furthermore, for different reasons around 5% of work permits do not end up in actual employment. There have also been instances of abuse, as by obtaining work permits, foreigners could obtain a permit to reside in Slovenia, and consequently, the possibility of travelling or residing in other countries (parties to the Schengen Agreement), where they afterwards worked, sought asylum or registered with the competent authorities as job-seekers. Most of these cases of abuse were related to Kosovo.

<sup>10</sup> This primarily refers to cleaners and similar jobs, as well as to recruitment through employment agencies.

<sup>11</sup> According to published data on issued work permits for foreigners by activity (see: <http://www.ess.gov.si/slo/Dejavnost/StatisticniPodatki/MesecneInformacije/MesecneInformacije.htm>), the number of work permits issued in the field of construction fell by 12,533 (27.2%) in the period from March 2009 and March 2010; in manufacturing, the number decreased by 2,221 (19.7%), while in distributive trades and transport together the number diminished by 1,726 (18.7%).

## 2.2. Employment according to the Labour Force Survey

**Higher employment is frequently one of the development goals of a society.** This is usually measured by the employment rate, which represents the ratio of the number of people in employment to the number of the population in a specific age group. One of the goals set by the EU in the Lisbon strategy in 2000 was to achieve so-called full employment or a 70% employment rate for the 15–64 age group by 2010, a level which, due to the crisis, will not be reached. Increasing the employment rate in the 15–64 age group to 70% by 2013 is also one of the objectives of Slovenia's Development Strategy, and this will also not be attained. In the debate on the 2020 EU targets, the employment rate remains an objective, although, because of the high level of participation of the young population aged 15–19 in education, the age group has been redefined. The new goal is to achieve a 75% employment rate in the 20–64 age group by 2020.

**The employment rate in Slovenia was rising until 2008.** In the 2000–2008 period, the employment rate of the 15–64 age group increased by 5.8 p.p. (to 68.5% in 2008); for men, it increased by 5.5 p.p. (to 72.7% in 2008), and for women by 5.8 p.p. (to 64.8% in 2008). Accelerated economic growth in 2004 contributed, in particular, to a sizeable increase in the employment rate of women (by 3.1 p.p. in 2004). The employment rate of the male population was positively affected by high economic growth in the 2006–2007 period, with particularly strong activity in the construction sector. According to our estimates, the Lisbon objective of

70% employment will probably not be achieved by 2013 due to the decline in 2009 and the anticipated stagnation or modest employment growth in the years to come, and we are very likely to see a jobless economic recovery in the coming years.

**The economic crisis resulted in reduced employment in 2009.** With the 7.8% fall in GDP in 2009, the employment rate of the 15–64 age group also dropped (1.1 p.p.). The drop observed in the male population (1.7 p.p.) was higher than in women (0.4 p.p.), which can be attributed to the fact that the economic crisis in 2009 primarily hit sectors that mainly employ men. By level of education, the most significant reduction in 2009 was observed in the employment rate of the low-skilled population and those with secondary education, while by age group the highest drop was recorded for the young. The reduction in the 15–24 group mainly resulted from decreased demand for labour through student-job agencies.

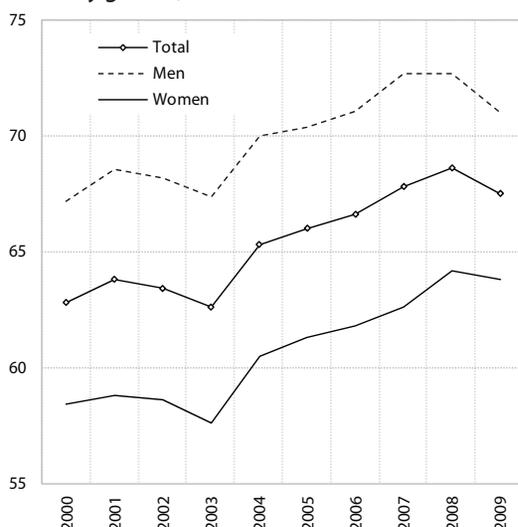
Table 2: Employment rates by age group, Slovenia, 2007–2009

	15–24	25–54	55–64	15–64
2007	37.6	85.3	33.5	67.8
2008	38.4	86.8	32.8	68.6
2009	35.3	84.8	35.6	67.5

Source: Eurostat.

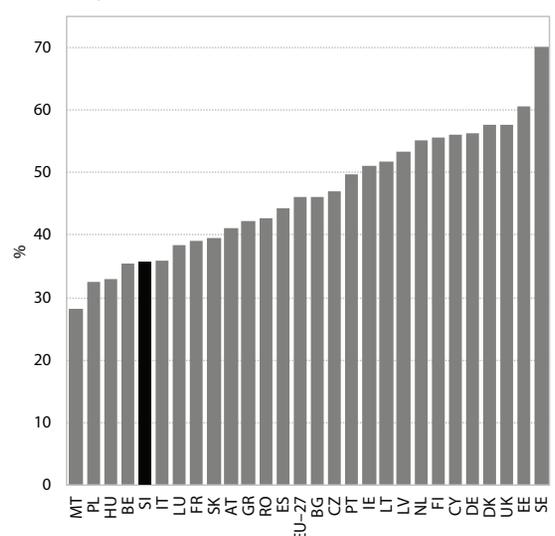
**Despite an increase in 2009, the employment rate of the elderly (55–64 years) is still low in Slovenia.** The implementation of the pension reform in 2000 contributed significantly to increasing the employment rate of the elderly (55–64 years), which

Figure 6: Employment rate in the 15–64 age group in Slovenia by gender, 2000–2009



Source: Eurostat.

Figure 7: Employment rate of the elderly (55–64 years) in the EU, 2009



Source: Eurostat.

rose by 10.8 p.p. in the 2000–2007 period, dropped slightly in 2008, and increased again in 2009 (see Table 2). The latter is mainly due to a higher volume of seasonal informal work. Despite the increase in the employment rate of this population group, it remains among the lowest in the EU (see Figure 7); this represents both a challenge and a window of opportunity.

### 2.3. Temporary and part-time employment

#### **Temporary employment and part-time employment are the most frequent atypical forms of employment.**

They typically help companies to adjust more rapidly to changing demand and have played an important role in labour-market adjustment during the recession. Temporary employment covers all types of temporary jobs, and is usually more common in economies that have strict recruitment and layoff rules and a higher level of seasonal work. Part-time employment,<sup>12</sup> on the other hand, allows employers to adjust to reduced workforce demand, but also makes it possible for employees to work shorter hours to achieve a better work-life balance and for other purposes. During the recession, temporary employment is expected to decline while part-time employment is expected to increase (all levels are presented as shares in total employment in the following text).

**With a slowdown and, consequently, a decline in economic activity, the steady growth in the prevalence of temporary employment in Slovenia came to a halt.** In Slovenia, temporary employment

Table 3: Shares of temporary employment in total employment by age group, Slovenia, in %

	15–24	25–54	55–64	15–64
2000	43.2	9.5	6.6n	13.7
2001	51.0	9.3	4.8n	13.0
2002	52.9	10.8	6.0n	14.3
2003	53.0	10.2	4.4n	13.7
2004	63.1	13.6	7.7n	17.8
2005	62.5	13.5	6.3n	17.4
2006	64.2	13.1	6.5n	17.3
2007	68.3	14.0	6.7n	18.5
2008	69.8	12.7	5.7n	17.4
2009	66.6	12.5	6.0n	16.4

Source: Eurostat.

Note n: statistically non-significant data.

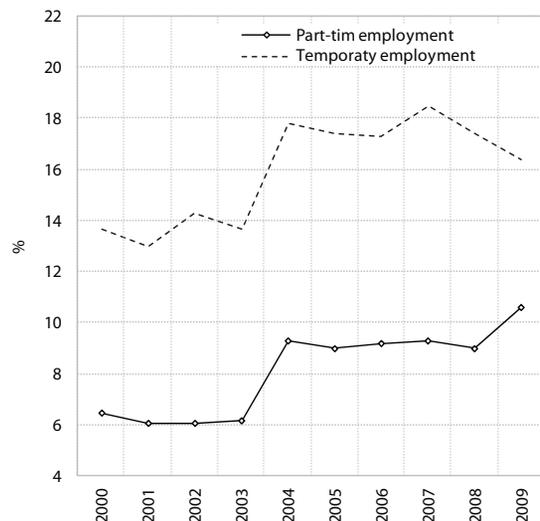
<sup>12</sup> In the Labour Force Survey, part-time employment is defined as people in part-time employment usually working less than 36 hours a week.

grew steadily until 2007, reaching 18.5% of total employment (of those aged 15–64) according to the Labour Force Survey. However, amid the slowdown and the decline in economic activity, the share of temporary employment diminished in 2008–2009 (see Table 3). To avoid dismissal costs, companies first responded to the crisis by not extending fixed-term employment contracts, which was (as in other countries) reflected in a lower share of temporary employment in total employment (16.4% in 2009). This share also declined because of reduced demand for student work.

#### **The Slovenian labour market is characterised by strong age segregation.**

There is a very high prevalence of temporary employment among the young. In 2009, as many as 76.9% of young female employees (aged 15–24) worked on a temporary basis, while the share of temporary employment in their male counterparts was 59.2%, giving a total share in this age group of 66.6% (see Table 3). Although the prevalence of temporary employment in the young population is also above average in other countries, we estimate that age segregation of the labour market is more prevalent in Slovenia than elsewhere.<sup>13</sup> The high prevalence of temporary employment among young people in Slovenia is also due to a high volume of student work, which is estimated to have covered 18.5% of all young people in employment in 2008 (Šušteršič et al. 2010).

Figure 8: Share of temporary and part-time employment in total employment in Slovenia, 2000–2009, in %



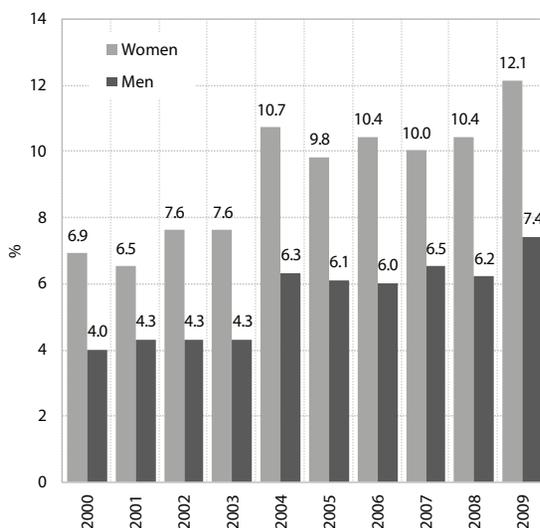
Source: Eurostat.

<sup>13</sup> This reflects the fact that the ratio of the share of temporary employment of the young (15–24 years) to the share of temporary employment of the working-age population (15–64 years) in Slovenia is far above the EU average, and over the past few years has been the second highest figure in the EU.

**The economic crisis brought about an increase in the prevalence of part-time employment in Slovenia.**

After five years of stagnation, the use of part-time employment in Slovenia started to grow once more during the economic crisis. Shortening working time is one of the possible ways for enterprises to adjust to lower demand, a measure which was in Slovenia, as in some other countries, supported through subsidies.<sup>14</sup> Up to the end of December 2009, the Employment Service of Slovenia (ESS), the institution implementing the relevant act, concluded 849 contracts to subsidise shorter work time for 64,769 workers. The share of part-time employment in total employment in the 15–64 age group increased by 1.4 p.p. in 2009 (to 9.5% of total employment), with the share for women (12.1%) remaining higher than the share for men (7.4%). According to our estimates, the implementation of this act contributed to increasing the prevalence of part-time employment in 2009.

Figure 9: Share of part-time employment in total employment by gender (15–64 age group) in Slovenia, 2000–2009



Source: Eurostat.

## 2.4. Unemployment

**Unemployment in Slovenia is measured in two ways:** through the Labour Force Survey, which yields internationally comparable data on the economic activity of the population, and through data on registered unemployment, based on the register kept by the Employment Service of Slovenia (ESS). As

unemployment data from different sources enable analysis that is complementary in terms of content, unemployment trends are shown according to both methods of measurement.

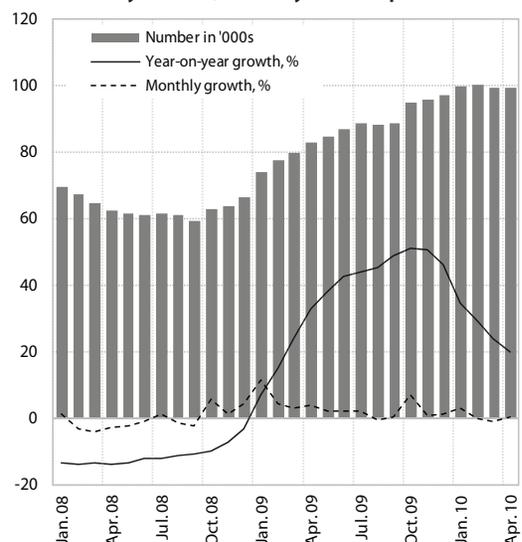
### 2.4.1. Registered unemployment

**With declining employment and economic activity, the number of registered unemployed persons increased in 2009, while in the first five months of 2010 it remained below 100,000.**

The number of registered unemployed persons had been decreasing since 1999, dropping amid the favourable economic situation in 2007–2008 to 59,303 by September 2008 (the lowest number of unemployed persons since 1990). With the onset of the economic crisis, the trend reversed in October 2008. By the end of 2009, the number of registered unemployed persons had risen to 96,672 (45.9% on a year-on-year basis), and by April 2010 to 99,316 (a higher number of unemployed persons was last recorded in March 2003). Although the number of registered unemployed persons grew more slowly in the first quarter of 2010 compared with the year before, the seasonally adjusted monthly growth rate has again been rising slightly since February 2010. However, with slower growth compared with the year before, year-on-year growth, at 16.4% in May 2010, is rapidly declining.

**The major reason for the increasing trend in unemployment figures is the high inflow of persons who lost work, even though the number of unemployed persons who have found a job has,**

Figure 10: Number of registered unemployed and their growth rates by month, January 2008–April 2010

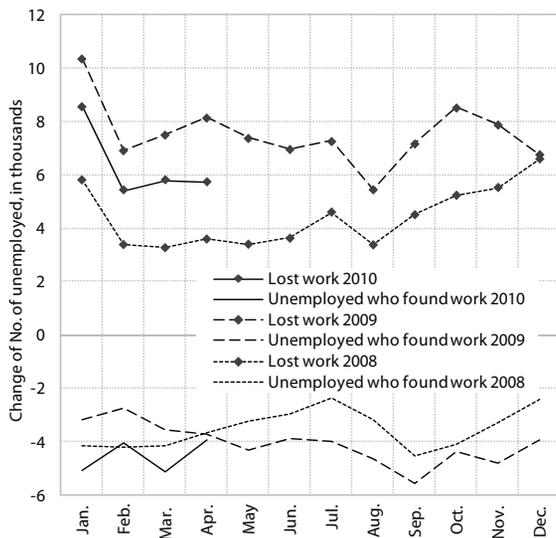


Source: SORS.

<sup>14</sup> The Partial Subsidising of Full-time Work Act was adopted in January 2009; a detailed analysis of its application is provided in Chapter 3.3.

since May 2009, been consistently higher than in the previous year. The two flows vary considerably from month to month, partly for seasonal reasons, but year-on-year both were much more favourable in the first quarter of 2010 than in the same period of 2009. The inflow of people who lost their jobs was 20% lower and the outflow into employment almost 50% higher than in the first quarter of 2009. The inflow of unemployed first-time job-seekers was also lower than in the previous year (by 11.6%) and the drop in the number of people who became unemployed for other reasons was larger (by 22.4%).

Figure 11: Inflow into unemployment due to a job loss, and outflow of unemployed persons into employment by month, 2008–2010, in '000s

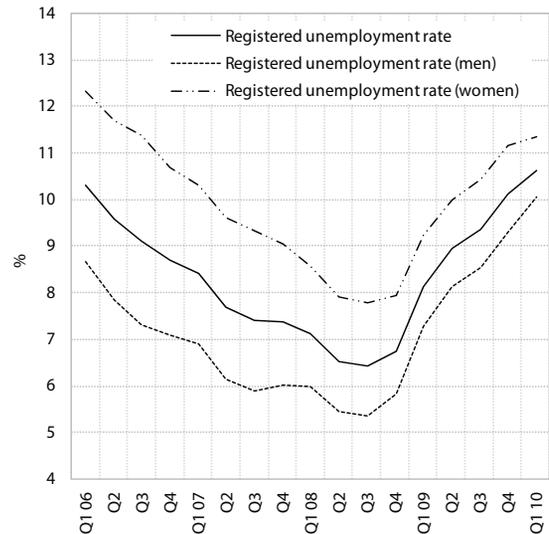


Source: ESS.

**An increase in the number of unemployed persons and a decline in the number of persons in employment resulted in a higher registered unemployment rate.**

Due to the rising number of persons in employment and the falling number of unemployed persons, the registered unemployment rate dropped to a level as low as 6.3% by September 2008 (the lowest since December 1990; the same applies to the number of unemployed persons). As a result of an opposite process, i.e. a falling number of employed persons and a rising number of unemployed persons, it then started to grow, reaching 10.3% by December 2009 (a level similar to that in February 2006, while the 2009 average was 9.1%). In the first quarter of 2010, the registered unemployment rate continued to rise, reaching 10.6%. The registered unemployment rate of women remains higher than the registered unemployment rate of men, although men have prevailed over women within the unemployed total since February 2009.

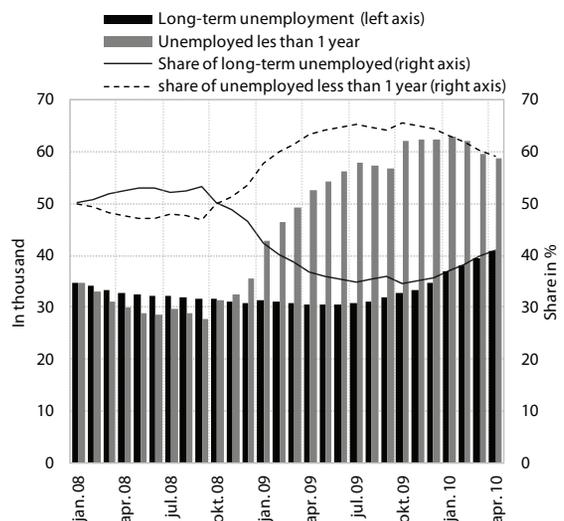
Figure 12: Registered unemployment rate by gender, by quarter, 2006–2010



Source: SORS, ESS; calculations by IMAD.

**Due to a strong inflow of newly registered unemployed persons at the onset of the economic crisis, the share of the long-term unemployed<sup>15</sup> in the total number of registered unemployed persons started to fall, but since November 2009 the trend has been upward again.** The small number of unemployed persons recorded in September 2008 still included as many as 31,583 (more than 50%) of the long-term unemployed, a number which, for various reasons, fell to 30,312 by May 2009. Due

Figure 13: Number and share of long-term unemployed in total number of unemployed persons



Source: SORS; calculations by IMAD.

<sup>15</sup> People unemployed longer than one year.

to a higher number of people losing their jobs, the number of registered unemployed persons has been rapidly increasing since October 2008, which resulted in a considerable increase in the share of people who had been unemployed for less than a year. Consequently, the share of long-term unemployed persons started to decline, reaching 34.4% by October 2009. Since November 2009, however, the increase in the number of long-term unemployed persons has been constantly larger than the increase in the number of people unemployed for less than a year, and consequently, the share of the long-term unemployed is again rising. By April 2010, it reached 40.9% and the number of long-term unemployed persons 40,638.

## 2.4.2. Unemployment rate according to the Labour Force Survey

**The economic crisis brought the trend of a falling unemployment rate to a halt.** The unemployment rate, measured by the Labour Force Survey, was on a falling trend until the end of 2008. It was 4.1% in the third quarter of 2008 and 4.4% in 2008 as a whole, the lowest values since measurements began. The economic crisis caused decreased labour demand: compared with 2008, the number of vacancies dropped by 36.7% in 2009, and the number of people in formal employment fell by 2.4%. In 2009, the unemployment rate therefore started to grow,

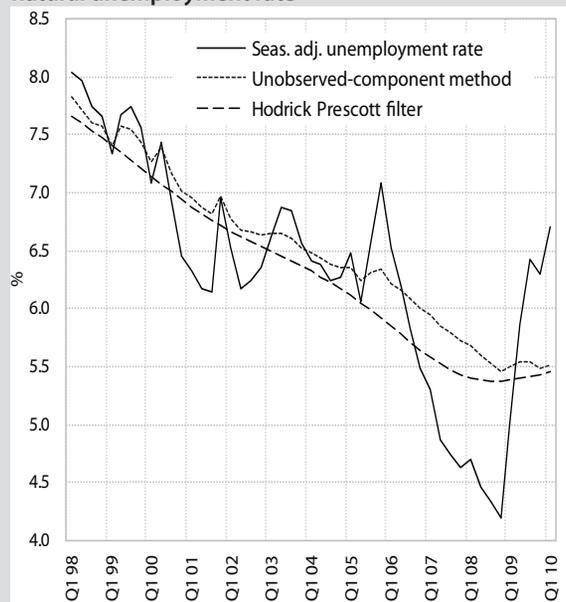
### Box 1: Natural rate of unemployment – NAIRU

#### **The calculation of the natural rate of unemployment (NAIRU) was based on a univariate method.**

The natural unemployment rate (NAIRU – the non-accelerating inflation rate of unemployment, consistent with stable prices) is a frequent method of analysing the sustainable level of production-capacity utilisation. In analysing structural reforms aimed at continuous reduction of unemployment, it is essential to identify the sustainable or trend component of unemployment, as this is the only way to assess the long-run efficacy of individual economic measures. Literature makes use of various methods for estimating the natural unemployment rate, which can roughly be classified into structural and statistical methods, and reduced-form models. Due to the shortness of the time series, a univariate analysis was selected, i.e. a statistical method for NAIRU estimation, splitting the actual unemployment rate into a cyclical component and a trend component, with the latter representing NAIRU. The underlying presumption is that there is no long-run trade-off between inflation and unemployment, i.e., that on average, the unemployment rate fluctuates around NAIRU, and self-stabilising forces within the economy are sufficiently strong to push unemployment back to its trend growth. Two methods of decomposing unemployment into cyclical and trend components were used. According to the Hodric-Prescott filter (HP), trend unemployment is identified as a weighted moving average of actual unemployment. The major weakness of this method is the problem of final values. In the case of stable inflation, the HP filter is not problematic, but in the event of falling/rising inflation, the NAIRU estimate is biased. The second method used was the unobserved-component method, assuming a first-order autoregressive process. The model is estimated using the Kalman filter. The major advantage of this method over the HP filter is the estimate of autoregressive coefficients. The autoregressive model is consistent with the assumption of NAIRU slowly adjusting to permanent supply shocks. Furthermore, the autoregressive coefficient estimates enable short-term forecasts of the trend component of unemployment.

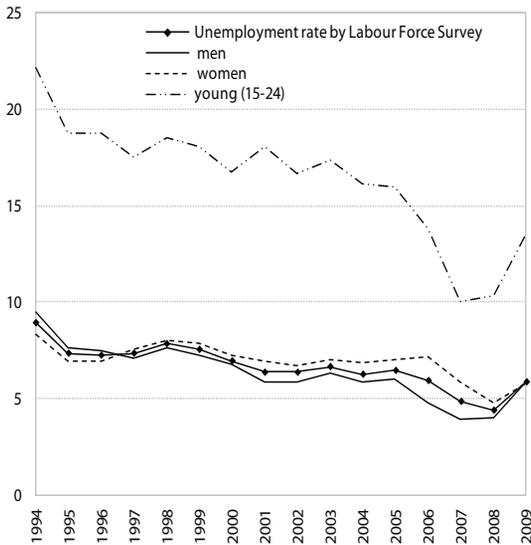
**After 2004, the gap between the actual unemployment rate and the natural unemployment rate widened considerably.** As seen in Figure 15, the actual seasonally adjusted unemployment rate fell below the level of the natural unemployment rate in the second half of 2006, which may have been the result of an acceleration of economic growth based on favourable global economic trends and domestic investment activity (construction). In 2009, which was characterised by a decline in economic activity, the actual unemployment rate again rose above the natural rate, with the gap between the two the largest ever.

Figure 15: Actual unemployment rate and estimated natural unemployment rate



Source: SORS, calculations by IMAD.

Figure 14: Unemployment rates according to the Labour Force Survey, Slovenia, 1994–2009, in %



Source: SORS, Eurostat.

reaching 6.4% in the last quarter and 5.9%, on average, in the year as a whole. The rising trend continued into the first quarter of 2010, when the unemployment rate was 7.1% (a rise of 1.7 p.p. over the same period in the previous year).

**In 2009, men were hit more by the economic crisis than women.** For the first time since 1996, the male unemployment rate was higher than the female unemployment rate, yet only in the first three quarters of 2009. In the last quarter, it again fell below the female unemployment rate, but the average rate for 2009 remained slightly higher than that for women. The sectors that were hit worst by the economic crisis were those that employ more men than women; the service sectors, particularly public services, which mostly employ women, were affected to a much lesser extent.

Table 4: Unemployment rates by age group

	15–24	20–49	55–64	Total
2000	16.4	5.6	7.3n	6.7
2001	15.7	4.7	4.2n	6.2
2002	14.8	5.1	4.3n	6.3
2003	15.3	5.9	4.2n	6.7
2004	14.0	5.3	4.5n	6.3
2005	15.9	5.8	4.3n	6.5
2006	13.9	5.5	3.9n	6.0
2007	10.1	4.4	4.1n	4.9
2008	10.4	3.8	3.5n	4.4
2009	13.6	5.5	4.2n	6.0

Source: Eurostat.

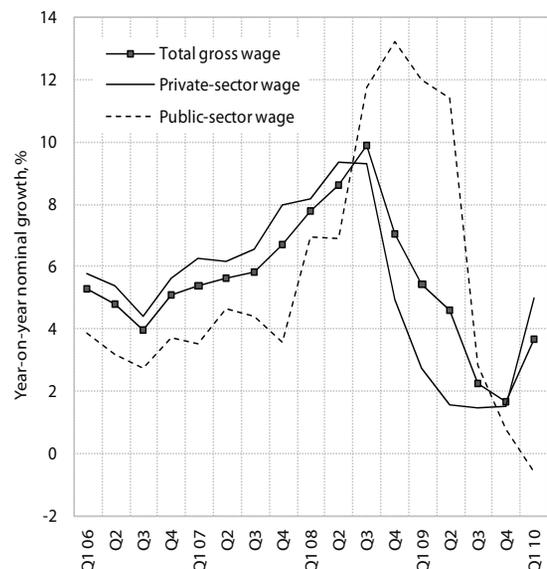
Note: n-statistically non-significant data.

**In 2009, unemployment increased most notably among the young.** Lower labour demand mostly affected the younger age group, as in the last quarter of 2009 the unemployment rate of young people (the 15–24 group) was 4.3 p.p. higher than in the previous year. In 2009, it was up 3.2 p.p. from 2008, whereas the increase in other age groups was considerably lower (see Table 4). The economic crisis made the transition of the young from education to employment more difficult. The unemployment rate in this age group also increased as young people are in general highly exposed to different forms of temporary jobs, which businesses began to cut first because these dismissals do not involve redundancy costs.

## 2.5. Wage movement

**After a drop in 2009, growth in wages in the private sector has picked up again in 2010, while in the public sector it has slowed after high growth last year (with the new wage system).** In the second half of 2008, the upward trend in wage growth in the private sector was interrupted by the economic crisis, tougher business conditions and a slump in orders. The private sector responded by reducing the volume of overtime work and by wage adjustments. In the same period, a wage reform took place in the public sector, which had been planned for several years and was aimed at eliminating wage disparities; this led to a rise in public-sector wages just as private-sector wages started to slow due to shrinking economic activity. Throughout 2009, the nominal growth in

Figure 16: Nominal growth in gross wage per employee



Source: SORS; calculations by IMAD.

wages in the private sector was adapting to new economic conditions and was considerably lower than the year before, while in the public sector, the elimination of wage disparities continued. The total growth in gross wage per employee was up 3.4% in nominal terms in 2009, which was substantially less than in the previous year (8.3%); taking into account the much lower inflation, its rise in real terms was exactly the same as in 2008 (2.5%). Although there was still a considerable gap between the average annual wage growth in public and private sectors in 2009, it narrowed towards the end of the year (also as a result of the two agreements on wages in the public sector). In the first quarter of 2010, wages in the private sector grew at a higher rate, also due to the base effect. A slowdown in wage growth in the public sector was a result of the measures taken in 2009.

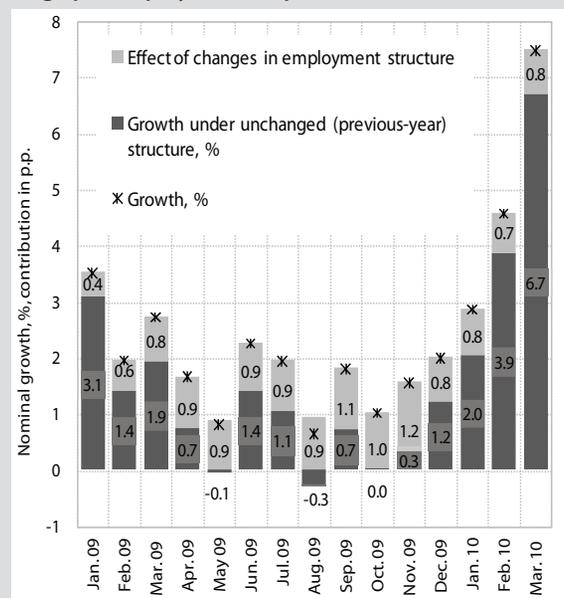
### 2.5.1. Wage movements in the private sector

**Against the backdrop of shrinking economic activity in 2009, the growth in gross wage per employee in the private sector slowed substantially, mostly by reducing payments for overtime work. It was also affected by the changed structure of employment and unexpectedly high extra payments at the end of the year in some activities.** Last year, the gross wage per employee in the private sector grew at the rate of 1.8% in nominal and 0.9% in real terms, which was considerably less than in the year before (7.8% and 2.0%, respectively). Higher than expected were payments of Christmas bonuses and 13<sup>th</sup> wages, which, despite the crisis, were only slightly more modest than in the previous

#### Box 2: The influence of changed employment structure on the growth in gross wage per employee

**Part of the growth in gross wage per employee in private-sector activities, as well as of total gross wage, is attributable to the changes in employment structure<sup>1</sup> resulting from the crisis. From October 2008, when the number of people employed with legal persons in the private sector began to slowly decrease, to March 2010, more than 46,000 people lost their employment, of which the majority were on low wages. Consequently, the share of employed persons on low wages has shrunk and the measured level of average gross wage per employee has risen. The effect of the changed employment structure on year-on-year wage growth was most pronounced in manufacturing, industry and the private sector. It in turn also affected the growth in the total gross wage per employee. On average in 2009, the nominal growth in gross wage in manufacturing stood at 0.8%; had the employment structure remained unchanged, it would have been 0.9 p.p. lower (-0.1%). The effect of the changed employment structure on growth is estimated to be the same (0.9 p.p.) in the gross wage in industry (activities B–F), in the private sector and in the total gross wage per employee. Without the structural effect or with unchanged structure of employment, the average growth in gross wage per employee in industry would have been a mere 0.4%, and in the private sector 0.9%, whereas the total gross wage would have risen by 2.5% (instead of the actual 1.3%, 1.8% and 3.4%, respectively). Also in the first three months of 2010, the contributions of the changed employment structure to wage growth remained similar to the average of last year, although the contributions in manufacturing (1.4 p.p.) and industry (1.2 p.p.) were even slightly higher, with these activities recording by far the highest growth in the average gross wage per employee this year.**

Figure 17: Breakdown of year-on-year growth in gross wage per employee in the private sector



Source: SORS, calculations by IMAD.

<sup>1</sup> The effect of the changed employment structure on the growth in gross wage per employee is calculated as the difference between the actual or officially published year-on-year wage growth (calculated from the weighted average of wages per employee and the current employment structure) and the year-on-year growth in the conditions of an unchanged employment structure (calculated from the weighted average of wages per employee and the employment structure of 2008). The calculation was made at the level of sections of the 2008 Standard Classification of Activities (SCA).

year.<sup>16</sup> November's growth in wages was exceptionally high (on average 29%) in four activities (water supply, electricity and gas supply, financial and insurance activities and mining); all these activities, except financial intermediation have a monopoly position on the market and are largely state owned; despite the hardened economic situation, they paid out a relatively high amount in 13<sup>th</sup> wages. Significant changes in the structure of employment, caused mostly by layoffs of those on low wages, led to a higher rise in the level of gross wage per employee (see Box 1). According to our estimates, payments of subsidised wage compensations in the last third of 2009 did not affect the level of average wages, as the number of beneficiaries was still very low and the guaranteed compensation stood at least at the level of the minimum wage. The trend of slowing year-on-year growth in wages, which started in mid-2008, continued in 2009, in particular in payments for overtime work, which slumped by 41.0% in 2009 from the level in the previous year.

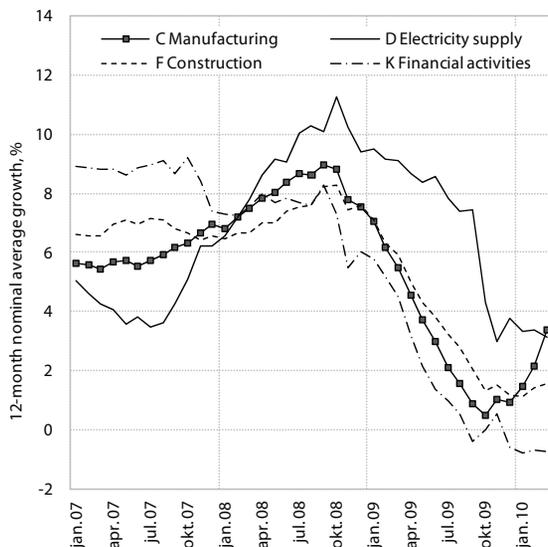
**Activities in the private sector responded differently to the crisis; however, due to several factors, growth in wages recovered in all these activities in the first quarter of 2010.** The general slowdown in the year-on-year growth in wages was first recorded in the last quarter of 2008, when the volume of payments of

13<sup>th</sup> wages dropped and wage growth consequently slowed in almost all activities. As Table P.1 in the Annex and Figure 18 show, the slowdown was greatest in financial and insurance activities, and manufacturing. In 2009, growth further eased in all activities; in the second and third quarters, it reached only one fifth of the growth recorded in the same period in 2008. In the last quarter of 2009, it bottomed out, being negative or averaging 0%, only to recover in all activities in the first quarter of 2010. In the conditions of the still-present base effect and the changes in the employment structure, wage growth increased by far the most in manufacturing, thanks to a slight rise in the volume of overtime work and a rise in the minimum wage.

**The first response of companies to the economic crisis was a reduction in the volume of overtime work, which did, however, slowly recover in recent months.** Table 5 shows the share of payments for overtime work in wages. The share of overtime payments in the private sector started to decline in the second half of 2008 and bottomed out in the first quarter of 2009, when it started to slowly increase once more. The share of overtime payments in wages dropped most in construction and manufacturing, the two activities that also saw the largest decline in the number of people in employment and in economic activity in general. Although the share of overtime payments in manufacturing has been rising once more in the last three quarters, it was still lower by almost a half in the first quarter in 2010 than before the crisis. The contribution of overtime payments to year-on-year growth in gross wage per employee in the private sector was on average positive in the first quarter, but still modest (overtime payments contributed a mere 0.2 p. p. to 5.0% growth) in the first three months.

**As a result of the Minimum Wage Act, companies had to pay minimum wages that were at least 9.7% higher this March,<sup>17</sup> which not only raised the number of recipients of the minimum wage, but also affected growth in the average private-sector wage.** In March, the number of recipients of the minimum wage rose to 43,323, or 7.0% of the total number of persons in employment. It rose most in trade (from less than 2,000 to more than 8,000) and in manufacturing (by almost 5,000 to above 11,000). Administrative and support service activities

Figure 18: Growth in the average gross wage per employee in selected private-sector activities



Source: SORS; calculations by IMAD

<sup>16</sup> In 2009, November payments of Christmas bonuses and 13<sup>th</sup> wages were higher than expected; despite the crisis, they were only slightly more modest than in 2008 (when they were much lower than in 2007, owing to the shrinking of economic activity). The average amount of these payments was EUR 683 in 2009, and EUR 698 in 2008; they were received by a similar share of employees (18.1% in 2009 and 19.9% in 2008).

<sup>17</sup> In the event of strained business conditions, companies have the legal possibility of a gradual transition to a new minimum wage amounting to EUR 655, which is lower than the amount set out by the new Act, which now stands at EUR 734, and is higher by 22.9% than the previous legally set minimum wage (EUR 597)

**Box 3: Changes in the minimum wage in 2010 and an assessment of consequences**

**A new Minimum Wage Act adopted in February 2010 not only raised the minimum wage level by 22.9% but also laid out a somewhat broader definition of minimum wage.** The definition of the right to a minimum wage for full-time work was preserved, but the elements for setting a new amount of minimum wage were redefined (growth in consumer prices, wage movements, economic conditions or economic growth and employment trends) and the adjustment mechanism was changed. The minimum wage will now be adjusted each January for at least the year-on-year growth in consumer prices in the previous year. The level of the minimum wage will be published by the end of January, after consultation with social partners. A new level of minimum wage has been set at EUR 734.15. Taking into account this new gross wage level and increased general tax relief for lowest wages, the net minimum wage stands at EUR 562, which is the estimated level of the minimum costs of consumer goods per person. As the percentage rise of the minimum wage was so high, the transitional provisions to the law allow for a gradual adjustment to the new level of gross wage by the end of 2011.

**The impact of the minimum wage rise on unemployment was analysed on the basis of estimated short- and long-term coefficients of the elasticity of employment to labour costs.** This elasticity was estimated by the dynamic labour-demand function based on company data for the period 1995–2007. The results of this analysis reveal how companies responded to increased labour costs in the past. In the short term, companies respond to a 1% rise in labour cost by a 0.44% cutback in employment, and in the long term, with a 1.49% cutback. If this mechanism is applied to the actual number of minimum-wage recipients and the actual distribution of wages is taken into account, the gross wage increased by 22.9% for approximately one third of new recipients, for another third it was up by 10.5% and for another third by only 3.7%. This means that, taking into account the short-term elasticity of labour costs, employment was down in the short term by 10.3% in the first group, 4.7% in the second group and 1.7% in the third group of employed people, which totals 5,151 potentially unemployed people. In the long term, employment would fall by 34.3%, 15.7% and 5.6%, respectively in the three groups of employed people, which altogether means 17,169 new potentially unemployed people. The long-term calculations include further adjustments in the economy, such as layoffs in companies that would use up short-term reserves, and closing down of companies that would not be able to increase value added and employ mostly low-skilled workers (Brezigar-Masten et al., 2010). All this applies under the assumption that other conditions, such as demand for final products and loans to companies remain unchanged. Pressures on other wages were also not included. And finally, the calculation of the potential number of unemployed people was based on the distribution of employed people by level of gross wage as of September 2008, which, for example, does not include the changes caused by the loss of jobs in 2009, which largely affected workers with low wages.

**Table 5: The share of payments for overtime work in wages, by activities, in the period 2008–2010, quarterly data**

	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
<b>PRIVATE SECTOR TOTAL</b>	1.6	1.6	1.5	1.2	0.8	0.9	0.9	1.0	1.0
A Agriculture, forestry and fishing	0.5	0.5	0.5	0.5	0.4	0.5	0.6	0.7	0.5
B Mining	2.3	2.5	3.3	4.2	2.6	2.0	2.2	1.8	1.5
C Manufacturing	2.4	2.4	2.1	1.4	0.8	0.8	1.0	1.2	1.4
D Electricity, gas, steam and air conditioning supply	2.0	1.9	2.2	1.6	1.9	1.9	1.8	1.5	1.5
E Water supply	1.9	1.9	1.9	1.7	1.7	1.7	1.4	1.5	2.6
F Construction	2.5	2.7	2.8	2.2	1.3	1.8	1.9	1.6	1.6
G Wholesale and retail trade	0.8	0.8	0.9	1.0	0.6	0.6	0.6	0.8	0.5
H Transportation and storage	1.1	1.3	1.2	1.1	0.9	1.1	0.8	0.8	0.8
I Accommodation and food service activities	0.7	0.8	0.8	0.6	0.5	0.5	0.5	0.4	0.4
J Information and communication	0.7	0.7	0.7	0.6	0.6	0.6	0.5	0.6	0.6
K Financial and insurance activities	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.2
L Real estate activities	0.6	0.5	0.4	0.5	0.6	0.6	0.6	0.6	0.5
M Professional, scientific and technical activities	0.8	0.8	0.7	0.6	0.7	0.7	0.6	0.6	0.6
N Administrative and support service activities	2.6	2.9	2.8	2.1	1.5	1.9	2.0	1.8	1.9
S Other service activities	1.0	1.1	0.7	0.7	0.7	0.7	0.6	0.6	0.6

Source: SORS; calculations by IMAD.

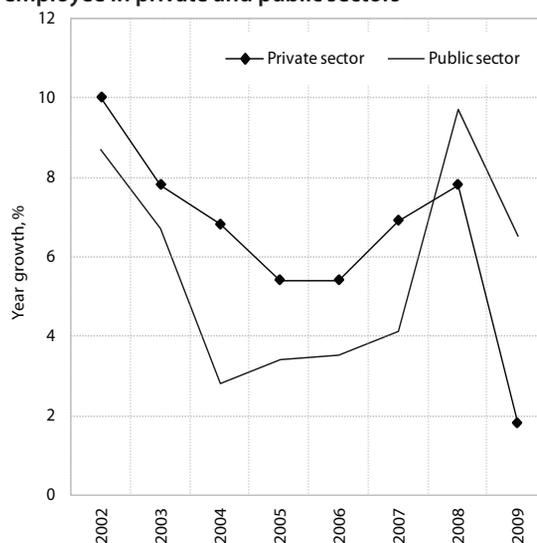
(activity N according to SCA 2008) had the largest proportion of minimum wage recipients – almost a third of all employed in this activity. Most minimum-wage recipients still come from manufacturing (26.6%), now followed by trade activity (19.0%), which surpassed administrative and support service activities, which had been ranked second before the minimum wage was raised (see table P.2 in the Annex).

### 2.5.2. Wage movements in public-sector activities

**During the lengthy preparations for the reform of the public-sector wage system, growth in wages in the public sector lagged behind that in the private sector.** In mid-2002, the Public-Sector Salary System Act<sup>18</sup> was adopted, which prevented the further possibility of introducing supplements to wages according to collective agreements for individual activities and occupations, which had previously raised wages in this sector out of the acceptable macroeconomic proportions. Since then, there have been only two factors affecting wage growth: the adjustment mechanism (slightly more restrictive than in the private sector) and promotion. As a result, the gross wage per employee in the public sector on average lagged behind that in the private sector by around 2 p.p. per year (in nominal terms by 2.2 p.p.) in the period 2002–2007. In 2008, the Collective Agreement for the Public Sector<sup>19</sup> and annexes to collective agreements for activities and occupations<sup>20</sup> were signed, and in August wages started to be paid out according to the new Public-Sector Salary System Act (including payments for the difference accrued since May 2008).

**The reform of the public-sector wage system coincided with the economic crisis, which called for government measures.** The introduction of the new wage system (disbursement of funds covering two quarters to eliminate wage disparities) led to a rapid rise in public-sector wages in 2008 and 2009. Gross wage per employee rose on average by 3 p.p. faster than gross wages in the private sector (in nominal terms by 3.3 p.p.). As the process of abolishing wage disparities coincided with the economic crisis, the social partners signed two agreements in 2009 with adjacent annexes to the collective agreement for

Figure 19: Nominal growth in average gross wage per employee in private and public sectors



Source: SORS; calculations by IMAD.

the public sector,<sup>21</sup> such that the disbursement of the third and fourth quarters of funds to eliminate wage disparities was postponed (to October 2010 and October 2011, respectively), and a stricter adjustment mechanism was introduced and payment of efficiency bonuses temporarily held up. These measures reduced growth in wages in 2009 (from an estimated 9.9%). Growth in gross wage per employee in this sector will also be much lower in 2010 than it would have been without these measures (in which case the nominal growth would have reached 10.3%). As Table 5 shows, thanks to these annexes, wage growth in the public sector will according to IMAD estimates (Spring Forecast), not diverge much from wage growth in the private sector in 2010; but the problem of wage-growth disparities has thus only been delayed to 2011 and 2012, which may prove quite challenging for a future wage policy to balance wage movements in the public and private sectors, as well as for sustainability of the public finances.

Table 6: Nominal growth in average gross wage per employee, %, 2008–2013

	2008	2009	2010	2011	2012	2013
Total gross wage	8.3	3.4	2.7	3.8	4.6	4.8
Private-sector wage	7.8	1.8	2.7	3.0	4.2	4.8
Public-sector wage	9.8	6.5	2.3	5.6	5.7	5.1

Source: SORS, IMAD – Spring forecast of economic trends 2010.

<sup>18</sup> Public-Sector Salary System Act, (Official Gazette of the Republic of Slovenia, No. 56/2002).

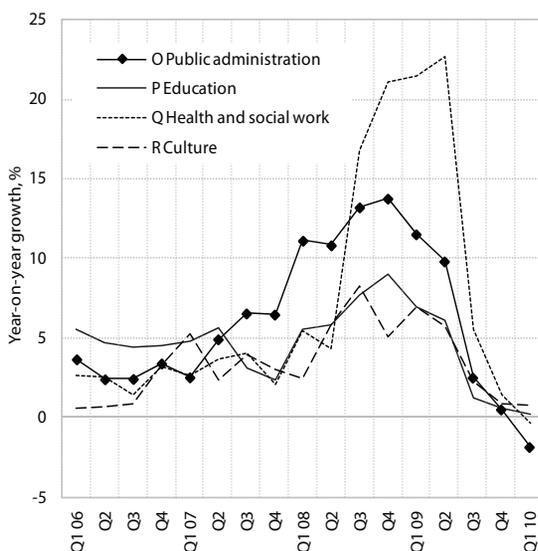
<sup>19</sup> Collective Agreement for Public Sector (Official Gazette of the Republic of Slovenia, No. 57/2008).

<sup>20</sup> Official Gazette of the Republic of Slovenia, No. 60 and No. 61/2008.

<sup>21</sup> Annex 1 to the Collective Agreement for the Public Sector, Official Gazette of the Republic of Slovenia, No. 23/2009, and Annex 2 to the Collective Agreement for the Public Sector, Official Gazette of the Republic of Slovenia, No. 91/2009.

**The effect of the wage-system reform varied across public-sector activities.** The aim of the reform was to establish more appropriate relations between wages across the public sector. Based on the reference jobs set out in the collective agreement for the public sector, corrections were most substantial in health and social work and cultural activities. There were least corrections of reference jobs in education, as, in the period 2003–2006, each year in July, around a 3% supplement to wages was paid in this area of work according to the Collective Agreement on Education, which was not the case for other public-sector areas. As Figure 20 shows, there was a substantial rise in wages in health and social work activities from the third quarter of 2008 to the second quarter of 2009 (the first quarter was paid in August 2008 and the second in January 2009). Wages in public administration also rose markedly; in the first half of 2008, they increased because of the increased workload due to Slovenia's Presidency of the EU, which was followed by disbursement of the first and second quarters of funds to eliminate wage disparities. A slowdown in wage growth in all activities in the second half of 2009 was the result of government measures (payments of regular efficiency bonuses were temporarily withheld, July wages were not adjusted for inflation, and the disbursement of the last two quarters of the elimination of wage disparities was postponed).

Figure 20: Year-on-year movement of gross wage per employee in public-sector activities (O–R), quarterly, 2006–2010

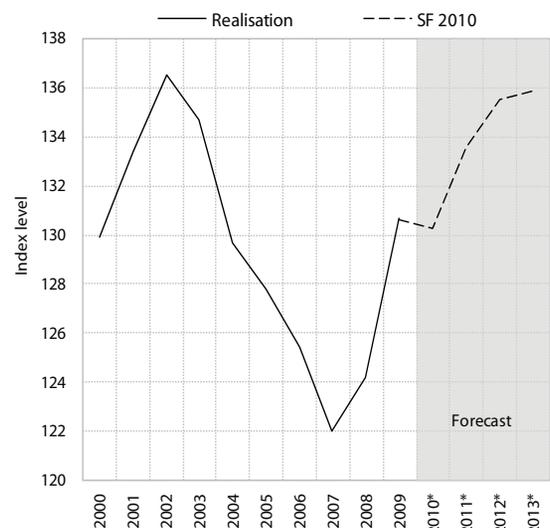


Source: SORS, SCA 2008.

### 2.5.2.1. Public- to private-sector wage ratios

**In the last two years, the public- to private-sector gross wage ratio widened.** In 2007, the average level of gross wages in the public sector was 22.7% higher than in the private sector, with this percentage further rising to 30.6% in 2009. Based on the assumptions incorporated in the two agreements on the measures for public-sector wages, signed in Annex 1 and Annex 2 to the Collective Agreement for the Public Sector, this difference is expected to further widen to 35.9% by 2013, according to the 2010 spring forecast, although the 2000 level had already been slightly exceeded in 2009 (see Figure 21).

Figure 21: Public- (activities O–R) to private-sector (activities A–N+S) gross wage ratios, 2000–2009 and forecast by 2013



Source: SORS, SCA 2002, for 2009 – SCA 2008; calculations by IMAD, and IMAD's Spring Forecast of Economic Trends 2010.

**In comparison with other countries, the ratio of gross wage in the public to the private sector is high in Slovenia.** International data on these ratios are calculated using data from the Structure of Earnings Survey, last released by Eurostat for 2006. According to the survey data for Slovenia, the ratio is even higher than that shown in the SORS data (see Table 8).<sup>22</sup> Even if comparison is done on SORS data for Slovenia (as Table 7 shows), only Cyprus has higher gross wages in all public-sector activities relative to the private sector, whereas Bulgaria, Latvia, Lithuania, Hungary and the already mentioned, Cyprus, have higher gross wages in public administration. The main reason for the difference between public- and private-sector

<sup>22</sup> The difference between SORS and Eurostat data stems from the coverage of data, which is in the SORS research almost complete, while Eurostat data are based on a survey.

wages is the educational structure of employees. The lower the educational level of those employed in the private sector in comparison with the public sector, the greater the wage disparities. Therefore, less economically developed countries usually record greater wage disparities between the two sectors. Hence, it is more appropriate to compare the wages of employees with the same level of education in the public and private sectors. According to these data, gross wages for those with secondary education are notably higher in public-sector activities in Slovenia (see Table P3 in Annex). However, even these data, for which the impact of educational structure has been neutralised, should be interpreted with caution, as for several EU countries no such data are available, which makes the comparison incomplete.

Table 7: Public- to private-sector gross wage ratios, %, EU countries and Norway, 2006

	Public administration	Education	Health and social work
Bulgaria	142.1	108.3	108.4
Czech Rep.	108.0	91.2	92.1
Germany	-	113.0	90.8
Estonia	108.4	86.1	91.6
Ireland	117.5	129.8	111.6
Spain	-	115.1	113.2
Cyprus	138.6	161.5	127.9
Latvia	148.5	105.3	102.9
Lithuania	150.8	92.9	102.6
Hungary	134.9	111.4	92.9
Netherlands	101.7	101.6	87.2
Poland	122.4	100.1	80.2
Slovenia	128.4	135.5	122.0
Slovakia	95.1	79.0	78.7
U. K.	92.8	96.0	96.6
Norway	-	100.0	94.7

Source: Eurostat, SES 2006, SCA 2002; calculations by IMAD.

**The public- to private-sector wage ratios serve as one of the many analytical tools driving public-sector wage policy.** Educational structure affects the changes in wage ratios in both sectors, but this effect is more pronounced in the long term. However, wage interventions, in particular in the public sector, where the wage-formation system is more centralised, have a more immediate effect on wage ratios. In the period 2000–2009, wage ratios in public-sector activities varied: by 2007, they were decreasing (except in education, owing to the supplement paid each July on the basis of the Collective Agreement on Education), and later they were rising. The ratio decreased mostly as a result of a partial adjustment of wages for inflation, while later it increased because of the new wage system. Even now, when only the first two quarters of measures aimed

Table 8: Public- to private-sector gross wage ratio, %, Slovenia, 2000–2009

	Public administration	Education	Health and social work
2000	137.8	124.3	126.5
2001	141.6	129.6	128.6
2002	139.3	133.8	135.3
2003	138.5	133.5	132.7
2004	130.3	131.5	126.0
2005	128.8	131.8	122.5
2006	126.0	131.0	119.3
2007	123.8	127.3	115.1
2008	128.9	126.4	119.8
2009	133.5	128.4	130.9

Source: SORS, SCA 2002, for 2009 SCA 2008; calculations by IMAD.

at abolishing wage disparities have been completed, the impact has been considerable. In 2009, the ratio of public-sector wages to those in the private sector reached the 2000 level, with wages in the public sector 30% higher than in the private sector. For individual areas, there has been a noticeable increase in the level of wages in education, health and social work.<sup>23</sup> Before 2006, the level of wages improved in education (the July wage supplement), while in 2008–2009, the level of wages strongly increased in health and social work, thanks to the reimbursement of the first two quarters aimed at eliminating wage disparities. These corrections stemmed from the findings of an analysis of public-sector wages carried out in 2001, when it was established that wages in education lagged behind, and that imbalances existed between those employed with higher education in different public-sector areas (lagging behind the wages of nurses). When the government at that time undertook to prepare a new public-sector wage system with the aim of abolishing these imbalances, the intention was not to increase the ratio of public-sector wages to private-sector wages.

## 2.6. Employment in public services

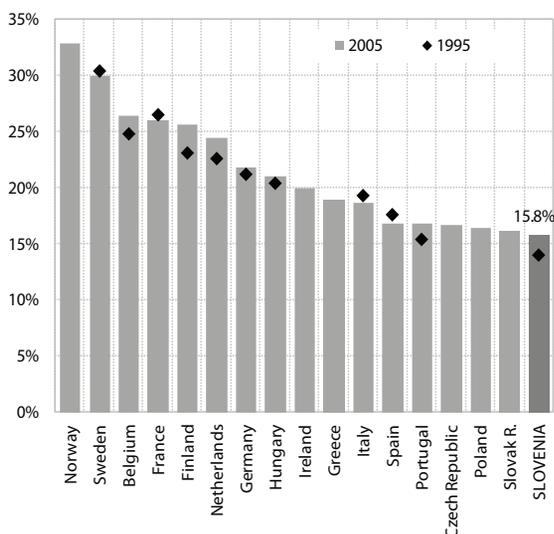
**Growth in public-sector wages and employment contributed to a wider fiscal deficit in 2009.** As noted in Chapter 2.1., during the economic crisis, employment in the private sector decreased and in the public sector increased. In terms of Slovenia's fiscal position, this also

<sup>23</sup> In 2008, 53% of those employed in public administration had higher education (in 2000, around 44%), in education this share was around 63% (in 2000, around 55%), while in health and social work this share was the lowest – around 38% (in 2000, around 28%). Of those employed in public administration, 44% had a secondary education, in education this share was around 30%, whereas in health it was the highest – 52%. The share of those employed with a low level of education is below 10% in these activities.

means that the base for contributions was reduced. On the expenditure side, expenditure for wages increased due to the wage-system reform and growth in employment, which contributed significantly to the existing fiscal deficit (for more detail, see section 2 in the Fiscal Development and Policy chapter). In view of the need for fiscal consolidation and the topical debates on the scope of public-sector employment, a comparative analysis was prepared on employment in public services.

**Compared with European countries, Slovenia has a relatively low percentage of people employed in public services (L–N).** According to the Standard Classification of Activities (SCA 2002), public services (L–N) comprise public administration (L), education (M), and health and social work (N). Cultural activities are included in the group of other community, social and personal services (O),<sup>24</sup> so international comparison is not possible. These activities comprise the following institutions: all public institutions and public institutes that are under the control of the government or municipalities, as well as concessionaries and purely private operators. Looking at individual activities (see Table 24), Slovenia has the lowest relative share of employment compared with other European countries in public administration (L); in education (M), Slovenia reaches the EU average, and in health and social work (N) it is well below the average. Denmark and Norway have three times the number of people employed in Slovenia in the last

Figure 22: Employment in public services (L–N) within the labour force, %, 1995 and 2005



Source: Eurostat, National Accounts; calculations by IMAD.

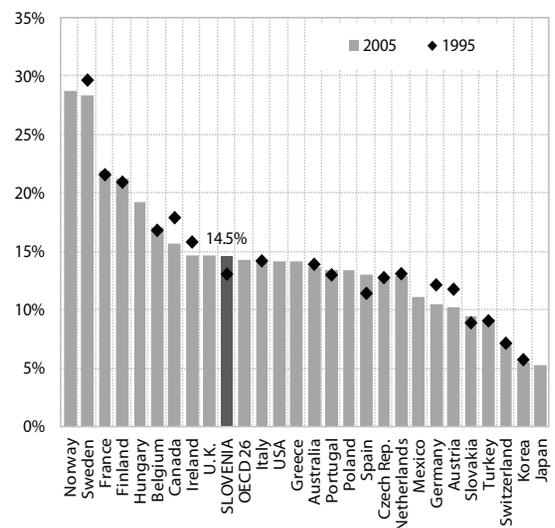
<sup>24</sup> A major part (around two-thirds) of the activities under O fall within the private sector, and public services (in culture) form only a minor part.

activity, which is mainly related to highly developed long-term care services.

**Despite the low share of people employed in public services (L–N), Slovenia is ranked at around the average of OECD countries in terms of the share of persons employed in the general government sector.**

Unlike the figures on employment in public services (L–N), which also include private operators, the general government sector (as defined by SNA) includes only the institutions founded by the government or municipality and for the most part (more than 50%) financed from public finances.<sup>25</sup> The differing position of Slovenia in the two international comparisons (Figures 22 and 23) thus largely stems from different manners of running and financing public services. A relatively lower share of people employed in public services (L–N) (see Figure 22) is a consequence of inadequate development of private provision of

Figure 23: Employment in general government as % of labour force, 1995 and 2005



Source: OECD Government at a Glance 2009, CEPD Survey, for Slovenia SORS; calculations by IMAD.

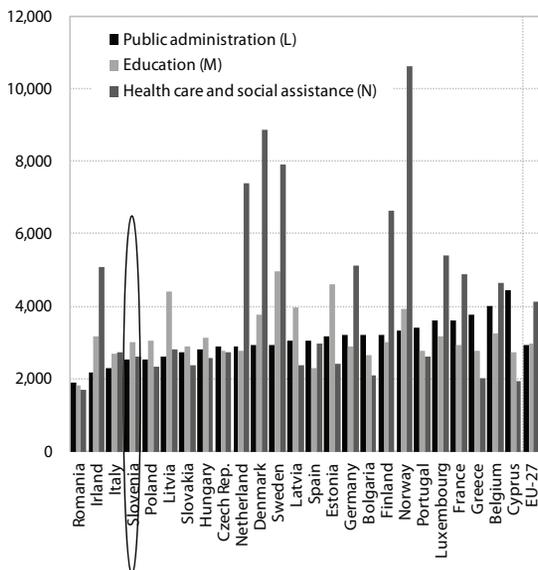
Notes: For Slovenia, Austria, Netherlands, Sweden and Switzerland, the full-time employed are included, for all other countries the data refer to the total number of employed. Austria: data for 2004 and 2005; Belgium: 2004, Finland: 2004 and 2005; France: 2004, some public institutions are not included; Poland 2004; Slovakia: activity groups L, M, N, rather than the general government sector.

<sup>25</sup> In Slovenia, these are: all direct and indirect users of the central and local budgets (included in the list of the Budgetary Users Register), except those that receive more than 50% of total revenues from private and other non-budget sources (some public agencies, homes for the elderly, some kindergartens, pharmacies, public institutions for education and training, health-care institutes, public institutes engaged in economic activities, agriculture). Regardless of the share of revenues from public sources, the general government sector does not include private operators with a concession for provision of public services (concessionaries), because neither government nor a municipality has a decisive influence on their governance.

these services, with or without concessions. On the other hand, a higher share of people employed in the general government stems from the fact that a large part of public services in Slovenia is still provided by public institutes that are related to the government or a municipality also in terms of governance, and are in large part financed from public sources (see Figure 23). Should adequate regulation and control be established, some public services could also be provided by private operators. This would not lead so much to reduced funding of public services, but more to slowing the growth in employment in the general government sector. Moreover, engaging the private sector in these services would also contribute to more rapid development of new services and higher employment in public services.

**Employment in public services has been increasing for several reasons.** In education, growth in employment is related to greater inclusion of children in pre-school care, greater variety of higher-education programmes, and promotion of adult education and lifelong learning. In health care, demand is higher because of population ageing, rapid development of medical technologies and greater awareness among the population. In social work, demographic changes have led to a rapid development of long-term care services. To meet these needs, there is still room for establishing new posts in these activities in Slovenia, but not for posts financed from public sources.

Figure 24: Employment in public administration, education, and health and social work per 100,000 inhabitants, according to National Accounts data for EU-27 and Norway, 2008

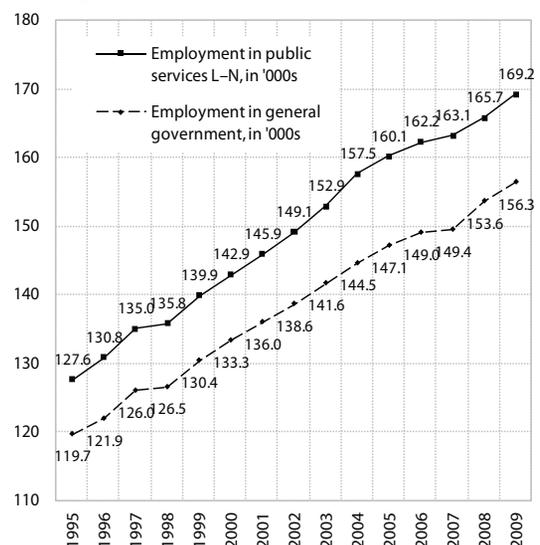


Source: Eurostat, National Accounts, SCA 2002.

Note: Countries are ranked by the share of employed in public administration. Data for France, Cyprus, Hungary and Romania for 2007, data for Portugal and Sweden for 2006.

**In the past, growth in employment in public services (L–N) in Slovenia almost exclusively stemmed from growth in employment in government- or municipality-controlled institutions financed mainly from public funds.** In 1995–2009, employment in public services in Slovenia (L–N) grew on average 2.0% per year, which was only slightly above the growth in the general government sector (1.9% yearly). As Figure 25 shows, employment in public services (L–N) grew almost exclusively as a consequence of growth in institutions controlled by the government or municipalities, and was in major part financed from public sources. As Figure 22 shows, in Finland, Belgium, Netherlands, Germany and Portugal, the percentage of people employed in public services in this period rose, but at the same time these countries managed to preserve the percentage of those employed in the general government sector at the same or even a lower level (see Figure 23). In most other countries included in the OECD international comparison, the percentage of people employed in general government decreased (Sweden, Canada, Ireland, Austria) or remained at the 1995 level (France, Italy, Czech Republic, Turkey, and Switzerland). Along with Slovenia, only a few countries (Spain, Portugal, Slovakia) failed to limit growth in the share of people employed in the general government sector or in institutions that are under government or municipality control and financed (more than 50%) from public sources by transferring the provision of some public services to the private sector.

Figure 25: Employment in public services (L–N) and in general government 1995–2009, in '000s



Source: SORS.

Note: IMAD estimate for 2009.

### 3. Labour-market policy measures in times of economic crisis in Slovenia

**The government took measures to respond to deteriorated labour-market conditions.** The government responded to the deteriorated situation on the labour market by more intensive implementation of the active employment policy measures and by passing two intervention acts aimed at preserving jobs. Although the unemployment benefit system has not changed, changes on the market led to an upsurge in the number of recipients of unemployment benefit. This chapter presents the changes in the active employment policy, the deficiencies of the income-security system for the unemployed and the implementation of the two intervention acts.

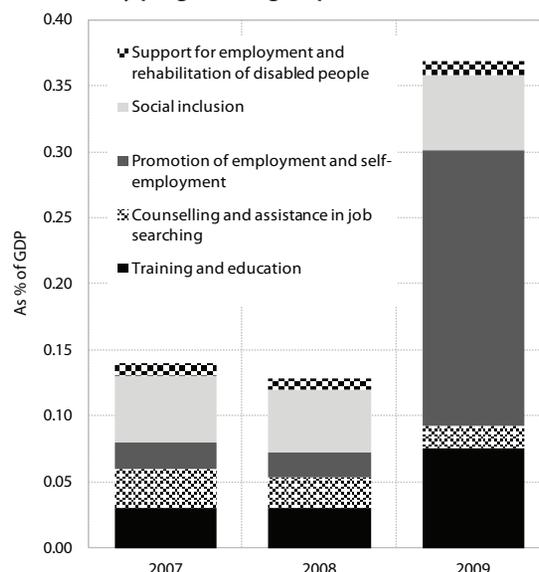
#### 3.1. Active employment policy (AEP)

**Active employment policy, which plays a significant role in times of economic crisis, should become even more responsive and effective.** In times of economic crisis, AEP plays an important role in counselling and guiding unemployed people, preserving and creating jobs, and upgrading skills and competences. Since 2007, AEP in Slovenia has included four programme groups: (i) counselling and assistance in job-seeking, (ii) training and education, (iii) promotion of employment and self-employment, (iv) programmes to boost social inclusion. Hereafter, we analyse expenditure on and participation in AEP measures in 2009.

**In 2009, expenditure on active employment policy measures increased, mostly thanks to intervention acts for preserving jobs.** In the period 2000–2008,

expenditure on active employment-policy measures, along with expenditure on the Employment Service of Slovenia accounted for 0.21% to 0.39% of GDP. In 2009, they soared to 0.5% of GDP (see Figure 26), mostly as a result of the implementation of two intervention acts aimed at preserving jobs, which are analysed in greater detail in Section 3.3. Expenditure for the Employment Service of Slovenia has been roughly at the same level since 2000, accounting for 0.13% of GDP in 2009.

Figure 26: Expenditure on active employment policy, as % of GDP, by programme groups



Source: Ministry of Finance; calculations by IMAD.

**In 2009, expenditure for promotion of employment and self-employment programmes increased most in this field.** Looking at the breakdown of expenditures by programme groups, most expenditure was earmarked for promotion of employment and self-employment programmes, which also includes expenditure on implementing the intervention acts. The share of expenditure for AEP programmes that lead to actual employment of unemployed people have increased. As mentioned in Section 2.1., around 13,000 unemployed people moved into a job under AEP in 2009 (15% more than in 2008), which

Table 9: Number and growth in the number of participants by AEP programme groups

	2008	2009	Index 2009/2008	I-III 2010	Index I-III 2010/I-III 2009
Total number of participants	29,085	52,975	182.1	14,196	132.4
Counselling and assistance in job searching	5,771	10,859	188.2	2,964	135.4
Training and education	12,839	20,530	159.9	4,474	118.4
Promotion of employment and self-employment	5,893	15,355	260.6	2,439	125.5
Social-inclusion programmes	4,582	6,231	136.0	2,810	153.7

Source: ESS; calculations by IMAD.

Table 10: Number and rate of participation of individual target groups in AEP measures, %

	Average no. of registered unemployed	Aged less than 26	First-time job-seekers	Women	Long-term unemployed	Less educated (levels I + II)	Aged 50 and more	Disabled
2007	71,336	41,228	36,768	28,199	27,037	18,275	8,630	8,754
2008	63,216	46,313	43,343	33,348	25,319	17,162	13,320	9,440
2009	86,354	72,104	69,385	56,322	36,052	33,835	19,838	15,858
<b>Number of all participants and participation of individual groups of unemployed people</b>								
2007	24,154	6,885	7,133	15,481	13,843	7,182	2,684	1,208
2008	29,085	6,669	7,325	17,608	12,938	6,882	4,076	1,586
2009	51,539	11,104	9,922	27,654	13,159	13,331	6,011	2,236
<b>Rate of participation in programmes, % (number of participants, as % of unemployed people in individual target group)</b>								
2007	33.9	57.8	51.5	39.5	37.9	25.6	12.1	12.3
2008	46.0	73.3	68.6	52.8	40.1	27.1	21.1	14.9
2009	59.7	83.5	80.3	65.2	41.7	39.2	23.0	18.4

Source: ESS; calculations by IMAD

contributed to a smaller drop in employment and slower growth in unemployment. Around EUR 60.8 million was spent on these measures<sup>26</sup> in 2009, up by 144% from 2008, with their share in the structure of expenditures increasing from 32% to 38%.

**The number of people participating in active employment-policy measures increased markedly in 2009.**

In 2009, around 53,000 persons participated in AEP measures, up by 82% from 2008. The rate of participation in AEP measures (measured as a ratio of the number of participants in AEP to the number of registered unemployed people) increased to 59.7% (in 2007, it was 34% and in 2008, 46%). As Table 9 shows, most people were included in training and education programmes, in particular institutional training programmes, where the scope of inclusion doubled in 2009. They were followed by employment and self-employment promotion measures, which saw the largest increase in participation in 2009 compared with 2008.<sup>27</sup> The number of participants also rose in measures under counselling and assistance in job-seeking programmes.<sup>28</sup> Public works form the major

part of social-inclusion programmes; 2009 saw 4,188 participants in these, up 6% from 2008. In the first quarter of 2010, the number involved in AEP measures continued to rise compared with the same period last year (see Table 9).

**In 2009, the rates of participation of women and first-time job-seekers in AEP increased most sharply.**

The structure of participation in AEP by target groups slightly changed in 2009 compared with the previous years: the highest rise in participation was recorded by young people (aged up to 26), unemployment-benefit recipients, and those who became unemployed due to bankruptcy and redundancies, as the inflow of these groups to unemployment also soared. As Table 10 shows, the rate of participation of individual groups (measured as a share of participants in AEP of each individual group in total unemployment of this group) rose most for women and first-time job-seekers. Much greater effort should be made for involvement of long-term and elderly unemployed people, as these groups recorded very modest participation rates. Given the large increase in the number of financial social-assistance recipients in 2009, the increase in the participation of these groups of unemployed people was relatively modest, which does not contribute positively to social inclusion of these people. As for increasing employability, greater inclusion of less-educated people would also be sensible. According to the data for 2009, those groups of the unemployed that are not generally ranked among the disadvantaged were more often included in these measures.

**The implementation of AEP programmes strengthened in 2009, but numerous deficiencies remain.** As Table 9 shows, the number of inclusions

<sup>26</sup> The measures leading to actual employment comprise public works, subsidizing of employment of various groups of unemployed and self-employment.

<sup>27</sup> In 2009, ESS granted 4,330 subsidies for self-employment to unemployed people (in 2008: 1,599). Assistance to self-employment also increased, reaching 6,545 inclusions, which was double the number recorded in 2008. The rest were various other forms of subsidies for employment, which decreased in 2009. Another measure taken in 2009 was the »Hire me« programme, related to employment of young people. It counted 2,904 inclusions, which were not available in the previous year.

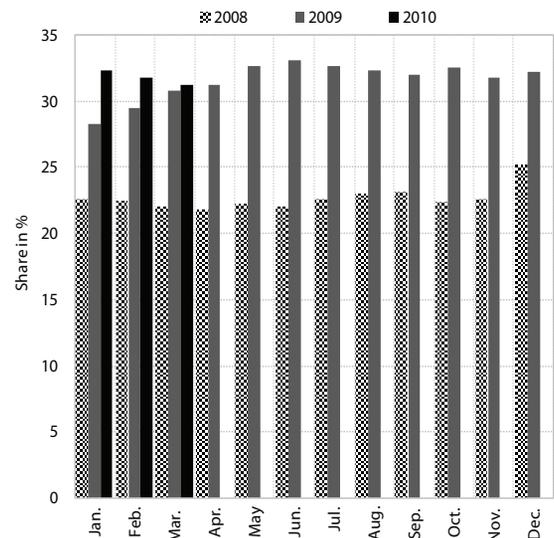
<sup>28</sup> This measures include assistance in career planning and job-seeking, where 7,770 inclusions were recorded (up from around 4,500 in previous years), and job-search clubs with 2,034 inclusions in 2009.

of unemployed people in AEP programmes surged in 2009, but an overview of measures reveals that more emphasis should in the future be given to: (i) quality counselling and assistance in job-seeking and career orientation, (ii) various forms of training for increasing knowledge and competences, (iii) development and implementation of innovative and development projects for jobs in the area of social inclusion and adaptation of jobs to elderly people, and (iv) connecting measures, e.g. career orientation and training, achieving synergies among institutions in implementing measures. Particular attention should be paid to analysis of the suitability of education and training programmes for meeting actual needs on the labour market. Given the increasing proportion of long-term unemployed people, more emphasis should be placed on programmes preventing the transition to long-term unemployment, and more long-term unemployed and less-educated people should be included in AEP programmes. Regular evaluation and comprehensive monitoring of implementation should be provided. In the process of development and budgetary planning, special attention should also be paid to planning and implementation, and measures should be precisely evaluated and defined in view of goals and their implementation properly adapted.

### 3.2. Passive labour-market policy measures

**Soon after the outset of the economic crisis, the number of recipients of unemployment benefits started to rise. Along with AEP measures, whose goal is to accelerate employment,** measures aimed at assuring an adequate income for the unemployed during the period of job-search are also important in times of crisis. As is the case in other countries' social-protection systems, this is provided for in Slovenia by unemployment benefit and financial-unemployment assistance, which existed until 2006. Unemployment benefits are regulated by the Employment and Insurance against Unemployment Act, and the right to this benefit is one of a group of passive labour-market policy measures. This measure has not been changed as a result of the strained conditions on the labour market; the same regulation applies as before the crisis. In October 2008, when the number of registered unemployed people started to grow, the number of recipients of unemployment benefit also started to rise: from 2008, when it was at its lowest (13,604), to December 2009, it surged 129% (to 31,162) and has continued to rise in 2010. The share of unemployment-benefit recipients in the

Figure 27: Share of recipients of unemployment benefits and financial unemployment assistance in total registered unemployment, %, 2008–2010

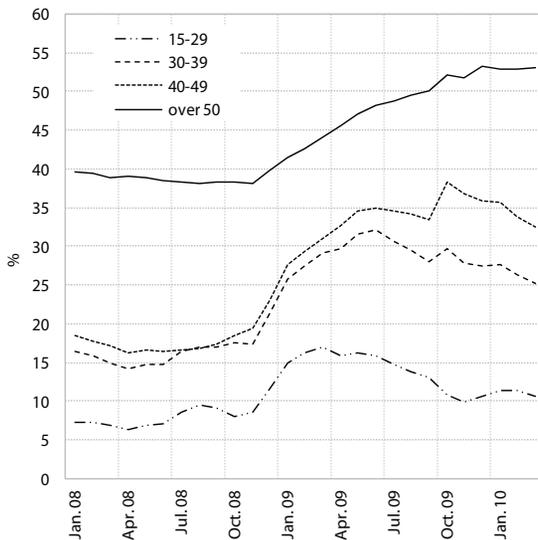


Source: ESS.

total number of registered unemployed people (see Figure 27) has also been on the rise. The share of recipients of unemployment benefits and financial assistance in the total number of unemployed people has also risen, mainly because of the increasing share of unemployment-benefit recipients as the number of financial-assistance recipients has been decreasing since 2006, when this form of support was abolished by law. Since 2006, it has only been distributed to beneficiaries who acquired the right to assistance before the legislation was changed. This right eventually expired in 2009.

**The causes of the rise in the share of recipients of unemployment benefits among the unemployed lie in current legislation, according to which the period of eligibility for benefits increases with the length of unemployment insurance.** During the crisis, the number of unemployed has risen in all age groups. Although this rise was somewhat higher in the younger age groups (15–29 years and 30–39 years), unemployment in older groups also increased (40–49 years and 50+). While the share of unemployed people over 40 years of age has been constantly slightly above 50% of the total number of unemployed people, their absolute number has been rising since September 2008. As the period of eligibility for unemployment benefit depends on the length of the insurance period, which is relatively short for the young, the rise in the number of older unemployed people with a longer period of eligibility led to a rise in the share of these recipients in total unemployment. The share of benefit recipients is the largest in the 50+ age group;

Figure 28: Share of recipients of unemployment benefits in the total number of registered unemployed, by age group, %, 2008–2010



Source: ESS.

according to the latest data for March 2010, it stood at 53.2% of the total number of unemployed people in this group. In the younger age groups, the share was lower (in the 15–29 group, it stood at 10.8%, in the 30–39 group, 25.4% and in the 40–49 group, 32.6%), although it increased in all age groups during the crisis.

**Legislation regulating unemployment benefits should be improved to adequately assure income security during unemployment and thereby support the concept of flexicurity.** Under current legislation, unemployment benefits are relatively low. In the first three months of unemployment, they amount to 70% and in subsequent months 60% of the average wage of the insured person in the 12-month period before unemployment occurred. The Employment and Insurance against Unemployment Act sets out that the lowest benefit accounts for 45.56% of the minimum wage, whereas the highest amount is three times the amount of the lowest. In 2009, the average level of gross benefit stood at EUR 562.2, accounting for 39% of the average gross wage. The period of eligibility is rather restrictive for unemployed people with a short insurance period, i.e. mainly the young, and more favourable for those with longer insurance period – elderly unemployed people. Income security assured by unemployment benefit is therefore rather weak for those groups of unemployed people with 1–5 years of insurance (3-month eligibility for benefit) and 5–15 years of insurance (6-month eligibility for benefit). As almost half of unemployed people are less than 39 years in age and young people generally get their first

employment relatively late and therefore have only a short insurance period upon unemployment, a large proportion of unemployed young people have only limited income security. Moreover, the unemployed are more exposed to the risk of poverty because of low incomes; this is also confirmed by the high level of risk of poverty of unemployed people, which has been on the rise in recent years (from 25.2% in 2005 to 36% in 2008).

### 3.3. Intervention acts aimed at preserving jobs

**In 2009, two intervention acts were adopted aimed at preserving jobs.** In January 2009, the Partial Subsidising of Full-Time Work Act was adopted, under which companies are eligible to a subsidy of EUR 60–120 per month for each employee included in the short-time working scheme. At the end of May, the Partial Reimbursement of Payment Compensation Act was adopted, which regulates partial reimbursement of wage compensations to employees who are on temporary layoff (“on waiting” at home). The employer may place a maximum of 50% of its workers on temporary layoff and should pay wage compensation to the worker in the amount of 85% of his/her average wage in the last three months. The state reimburses to the employer 50% of this compensation. Workers on temporary layoff have a right and obligation to spend 20% of their time on training. Training programmes must be provided by the employer, but are co-financed by the state in the amount of EUR 500 per employee.

**As the two acts entered into force, companies showed great interest in these subsidies.** As economic activity slowed and employment shrank in the last quarter of 2008 because of the crisis, the Partial Subsidising of Full-Time Work Act, which was adopted in January 2009, stirred great interest among companies.<sup>29</sup> According to the ESS data on subsidies paid for employees in the individual months of 2009, the number of full-time work subsidies has been rising till June 2009 (see Table 11). From February (the start of payments) to December, subsidies for short-time work were paid for 32,540 employees on average per month, which is 4.2% of employed people in this period. The further slowdown in economic activity in the first half of 2009 also led companies to apply for partial reimbursement of wage compensations, when the second intervention act entered into force. More than half of all the companies that applied for this type

<sup>29</sup> Companies submitted more than a half of all applications for full-time work subsidies in the first quarter of 2009.

of assistance in 2009 applied in the first two months (June and July). However, the second scheme was less attractive to companies and fewer employees were included. According to ESS monthly data on partial reimbursements of wage compensations, the number of employees who received wage compensation was the highest in September (see Table). In the period from July (the start of payments) to December, partial reimbursement of wage compensation was paid for 4,841 employees on average per month, which is 0.6% of total employment in this period. Around EUR 9.7 million was spend for this purpose in 2009, and around EUR 29 million was paid to companies for subsidising full-time work.

**Table 11: Number of employees subsidised within companies under the two intervention acts, monthly**

	PSFTW	PRPC
Feb.09	25,664	
Mar.09	34,846	
Apr.09	39,871	
May.09	40,562	
Jun.09	41,780	
Jul.09	37,297	3,932
Aug.09	34,114	5,035
Sep.09	31,771	5,883
Okt.09	24,145	4,769
Nov.09	25,219	5,144
Dec.09	22,671	5,429
Jan.10	13,520	3,674
Feb.10	9,009	4,859

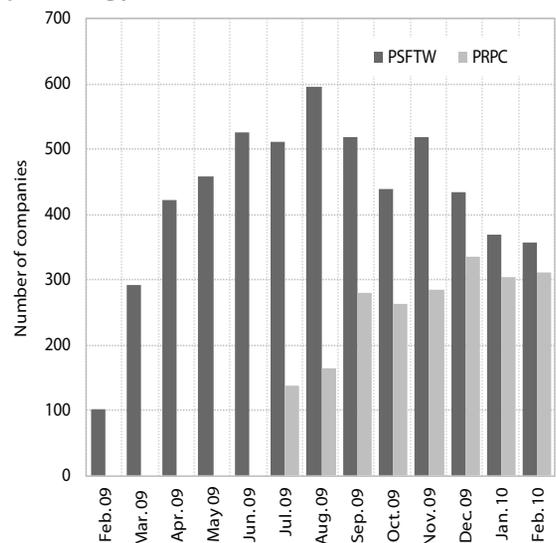
Source: ESS.

Note: PSFTW – Partial Subsidising of Full-Time Work Act, PRPC – Partial Reimbursement of Payment Compensation Act

**In their efforts to preserve jobs, companies more often used shorter working hours than temporary layoffs.** According to ESS monthly data on subsidies paid to employers in 2009, the number of companies that were granted a subsidy for full-time work was highest in August, whereas the number of companies receiving partial reimbursement for wage compensation was highest in December (see Figure 29). Subsidies for full-time work were on average paid to 437 companies per month, and partial reimbursement for wage compensation on average to 243 companies per month in the period of implementation of the acts.

**Both measures aimed at preserving jobs were used to the greatest extent by manufacturing companies, with transport and storage activity also standing out in terms of share of employees included in the schemes.** As manufacturing was

**Figure 29: Number of companies receiving subsidies for preserving jobs under intervention acts**



Source: ESS.

Notes: PSFTW – Partial Subsidising of Full-Time Work Act, PRPC – Partial Reimbursement of Payment Compensation Act.

strongly hit by the economic crisis, around a half of employers who concluded a contract with ESS on partial reimbursement of wage compensations and subsidies for full-time work were manufacturers. In this activity, it was mostly large companies that decided to apply for the scheme; the share of manufacturing in the total number of employed people involved is therefore even larger (76% in reimbursement of wage compensations and 80% in full-time work subsidies). As Table 11 shows, 4% of all manufacturing companies concluded a contract on partial reimbursement of work compensation, for a total of 7.2% of those employed in manufacturing, and 5% of companies concluded a contract on subsidies for full-time work for 27.7% of the employed. Transport and storage stand out, with 5.9% of those employed included in the partial-reimbursement scheme and 15.6% of those employed included in the full-time work scheme. This is largely a consequence of the inclusion of Slovenian Railways in the scheme, as its employees represent the majority of all those included from this area of work.

**A half of all employees included in the two schemes in manufacturing come from manufacture of ICT products, electrical equipment and metal industry, although numerous other activities also used the schemes.** Those employed in manufacture of ICT and electrical equipment hold the largest share of those included in both schemes (27.2% of all included persons in manufacturing), followed by metal industry (22.8%). The scheme includes the activities that were directly hit by the crisis (some export-

**Table 12: Share of companies and persons for whom a contract was concluded under the two intervention acts in the total number of companies and wage recipients in selected activity, %, 2009**

	PRPC		PSFTW	
	Share of companies	Share of persons in %	Share of companies	Share of employed
A Agriculture, forestry and fishing	0.9	0.4	0.9	5.5
B Mining	1.5	0.3	2.8	4.5
C Manufacturing	4.0	7.2	5.0	27.7
D Electricity, gas, steam and air conditioning supply			0.4	1.1
E Water supply, sewerage, waste management and remediation activities	1.1	0.5	1.1	0.7
F Construction	0.8	0.9	0.7	2.5
G Wholesale and retail trade, repair of motor vehicles and motorcycles	0.5	0.3	0.8	1.8
H Transportation and storage	0.5	5.9	0.6	15.6
I Accommodation and food service activities	0.7	1.1	0.6	1.5
J Information and communication	1.0	1.2	0.6	0.7
K Financial and insurance activities	0.2	0.0	1.0	2.8
L Real estate activities	0.5	0.5	0.6	2.7
M Professional, scientific and technical activities	0.5	0.8	1.7	2.4
N Administrative and support service activities	0.9	0.5	0.8	2.3
P Education	0.1	0.04	1.0	3.2
Q Health care and social assistance	0.2	0.05	0.2	1.5
R Culture, leisure and recreation activities			0.7	2.6
S Other service activities			1.1	6.5
Total	1.0	2.7	1.3	12.3

Source: SORS, calculations by IMAD.

Note: PSFTW – Partial Subsiding of Full-Time Work Act, PRPC – Partial Reimbursement of Payment Compensation Act

oriented and technologically demanding activities)<sup>30</sup> and activities where production further shrank because of the crisis (mainly technologically less demanding activities and those oriented towards the domestic market)<sup>31</sup>. As a result of the drop in foreign demand, the volume of production, particularly in export-oriented activities, slumped (year-on-year) at the end of 2008 and in the first months of 2009. In technologically less demanding activities, which are predominantly oriented to the domestic market, the drop in production activity deepened at the outset of the crisis and in 2009. As Figure 30 shows, the volume of production of export-oriented activities has already started to slightly increase, which is also reflected in waning interest in the two schemes (see Table 11).

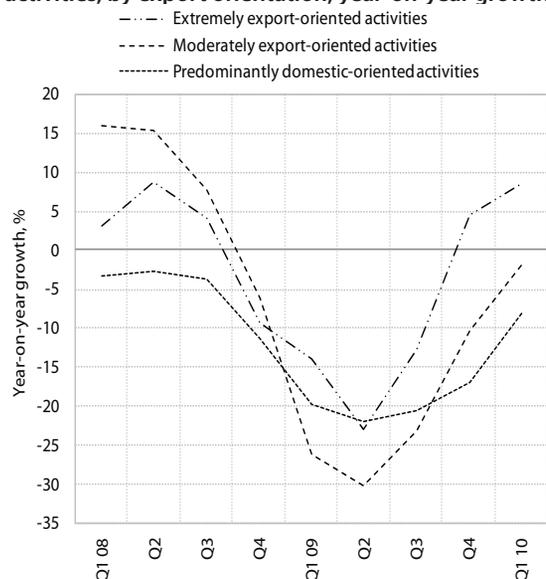
### It was mainly companies from the manufacture of other machinery and equipment, and manufacture of computer, electronic and optical equipment

<sup>30</sup> Manufacture of ICT and electricity products, manufacture of other machinery and equipment and manufacture of transport equipment.

<sup>31</sup> Metal industry, other manufacturing (which is technologically less demanding) and wood and furniture manufacture, which is predominantly oriented to the domestic market (and technologically less demanding).

**that applied for the partial reimbursement of wage compensation scheme.** The sector of manufacture of other machinery and equipment, and manufacture of computers, electronic and optical equipment had

**Figure 30: Production volume of manufacturing activities, by export orientation, year-on-year growth**



Source: SORS; calculations by IMAD.

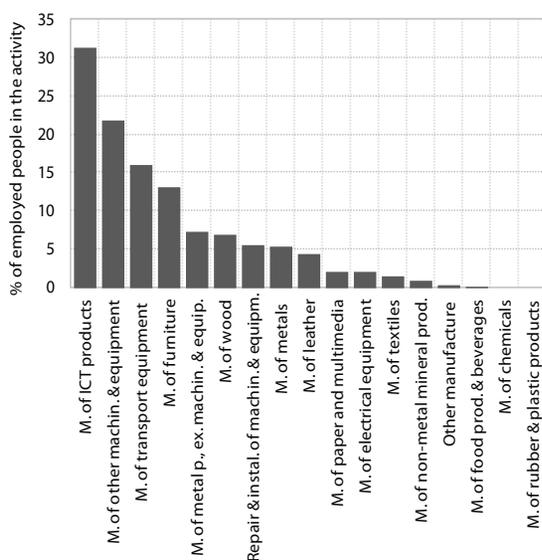
the largest share of employees included in the partial reimbursement of wage compensation scheme within manufacturing (25.4% and 19.2%, respectively). Both activities are also ahead of other activities in terms of the share of employees included in the scheme; in manufacture of computers, electronic and optical equipment, 31.4% of those employed in the activity were included in the scheme, and in manufacture of machinery and equipment, 21.8% of those employed in the activity (see Figure 31).

**More effort should be made to ensure that employees on temporary layoff obtain new knowledge during a time of economic crisis.**

Under the Partial Reimbursement of Payment Compensation Act, companies are obliged to provide education and training programmes for employees on temporary layoff, which are co-financed by the state, but, according to ESS data, these programmes have only been carried out to a modest extent. The appropriateness of this education in increasing employability is also questionable, as most of the companies organised internal education programmes led by internal mentors. As we pointed out in the previous year, institutions with appropriate knowledge should also be included in the preparation of education and training programmes for employees on a temporary layoff (e.g. the Slovenian Institute of Adult Education, ESS) (IMAD Economic Issues 2009).

**The majority of employees included in the partial subsidising of full-time work scheme came from manufacture of electrical equipment and metal**

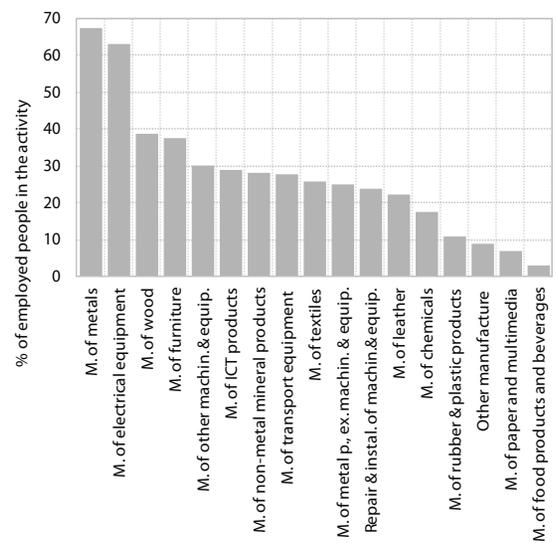
Figure 31: Share of employees included in the partial reimbursement of wage compensation scheme, by manufacturing activities, %



Source: ESS, SORS; calculations by IMAD.

**industry.** Of the total number of employees in manufacturing included this scheme, employees in the metal industry (24.2%)<sup>32</sup> and manufacture of electrical equipment (24.0%) held the largest shares. These activities also had the largest share of employees included in the scheme within the activity, in particular the manufacture of metals, in which 67.4% of employees participated in the scheme (see Figure 32). As the Partial Subsidising of Full-Time Work Act does not set out criteria that would condition the allocation of subsidies to crisis-related problems, companies in several areas of work applied for subsidies even though their problems might not have fully originated from the crisis.

Figure 32: Share of employed people included in the partial subsidising of full-time work scheme, by manufacturing activity



Source: ESS, SORS; calculations by IMAD.

<sup>32</sup> Metal industry comprises manufacture of metals, contributing 11.4% of those included in the scheme, and manufacture of metal products, except machinery and equipment, with 12.8% of those included.

## 4. Conclusions and challenges

***The economic crisis significantly affected the Slovenian labour market in 2009 and the main challenge is to restore employment growth.*** The number of people in employment dropped by 5.2% from October 2008 until March 2010, and in the private sector by as much as 8%. Registered unemployment increased by 67.4% between September 2008 and April 2010. Even though growth in registered unemployment eased notably in the last five months, which may lead to the conclusion that the labour-market deterioration has slowed in 2010, restoring employment growth and reducing unemployment remain the two main challenges to economic policy, given the great risk that Slovenia may see a jobless recovery and unemployment hysteresis in the coming years.

***Slovenia also faces a problem of age segmentation on the labour market. The prevalence of temporary employment declined in 2009, as during the crisis, enterprises first reduced employment by not extending contracts for fixed-term employment, a type of employment that is particularly frequent among the young.*** Nonetheless, the proportion of temporary jobs among young people (15–24 age group) is still much larger than in other age groups and among the largest in the EU. As labour-market segmentation by age largely results from student work, this may reduce significantly with the adoption of the draft Mini Job Act. However, as this act extends the right to perform "mini jobs" to unemployed and retired people, the share of temporary employment in other groups may increase, bringing about a new segmentation of the labour market. The implementation and consequences of the Mini Job Act should therefore be closely monitored.

***The elimination of wage disparities in the public sector is half complete, but continuation of the process poses a challenge.*** Wage reform in the public sector was intended to change internal wage ratios in the public sector, but the ratio of public-to private-sector wages also changed significantly after the first two quarters of funds allocated to the elimination of disparities were paid; this was not the purpose of the reform. In 2009, the ratio between the average gross wages in the public sector and in the private sector already exceeded the ratio from 2000 (before the reform), and will also increase substantially in the coming years, in our estimation. The ratio of the public- to private-sector gross wage in Slovenia had already been high in 2006, compared

with other countries, according to Eurostat's data. An international comparison of relative public- and private-sector wages also shows that public-sector employees with secondary education have relatively higher earnings than in other countries. As another two quarters of funds are yet to be paid to eliminate wage disparities in the public sector, wage policy faces the challenge of how to complete the reform without impairing the relationships between the public and the private sectors. The increase in public-sector wages and employment also translated into a higher government deficit in 2009. The need for public services is increasing for demographic and other reasons, but it will be necessary to provide systemic solutions to ensure the creation of jobs in this area, which will not only be funded from public sources.

***Active employment policy must pay particular attention to the fact that the number and share of long-term unemployed people, as well as the unemployment rate of young people, are once more rising.*** After declining in the first half of 2009 due to a significant inflow of newly unemployed people, the share of long-term unemployed people in the total number of unemployed people resumed growth towards the end of the year, and this requires attention and active employment-policy measures. Given that long-term unemployment reduces an individual's opportunities to find a new job, it is necessary to devise and expand programmes preventing the transition into long-term unemployment and to increase the participation of long-term unemployed people in active employment-policy schemes. As the unemployment rate of young people increased most notably in 2009, special attention should also be devoted to this group of unemployed people within labour-market policy and educational policy.

***The volume of funds for the implementation of active employment-policy schemes increased during the economic crisis, but weaknesses in the implementation of schemes persist.*** The participation rate (measured as the ratio of the number of participants in a certain group of unemployed people to the total number of the unemployed in the same group) rose most notably for women, but the participation rate of long-term unemployed people and those older than 50 increased marginally, which heightens the risk of persistent unemployment in the years to come. Growth in the number of financial social-assistance beneficiaries included in the AEP schemes is relatively modest, which is also unacceptable from the perspective of social inclusion. Active employment policy has certain weaknesses, which have also shown during the economic crisis. More emphasis should be placed on providing high-quality counselling and assistance to unemployed people seeking work, and

development and implementation of development programmes for new jobs in the area of social inclusion. Another important challenge is continuous assessment and comprehensive monitoring of the effectiveness of measures, particularly the contents and forms of education and training programmes for unemployed and employed people. Building new skills relevant for the labour market and adjusting training programmes to different target groups (from older and less qualified people to young people without work experience) will be crucial in enhancing the competitiveness of Slovenia's economy in the future (in restructuring towards more demanding products and services). Training is, at the same time, also one of the tools that should help to eliminate structural unemployment.

***The time of crisis also requires changes in the system providing income security of the unemployed, which have not yet been made in Slovenia.*** As Slovenia has not changed the unemployment-insurance system during the crisis, its weaknesses have become all the more visible. The share of unemployed young people (aged 15–29) receiving unemployment benefits increased only temporarily in 2009 and remains relatively low, which is a result of the relatively short period of entitlement to unemployment benefits and strict eligibility criteria for the young. The legislation governing unemployment benefits should be improved as soon as possible to ensure income security for the unemployed in the time of crisis and at the same time to support the concept of flexicurity. This will be partly addressed by changes brought about by the new draft Labour-Market Regulation Act, but we estimate that these changes will be adopted too late to provide income security for unemployed people during the crisis.

**Schemes to preserve jobs were most extensively used by enterprises in the manufacturing sector.** The government adopted two emergency acts to preserve jobs (the Partial Subsidising of Full-time Work Act and the Partial Reimbursement of Payment Compensation Act). Enterprises have shown great interest in both intervention acts since their adoption; however, towards the end of 2009, their interest began to fade due to the gradual recovery of economic activity in manufacturing, where subsidy schemes were most extensively used. According to ESS data on payments, around 4,800 wage compensations, on average, were reimbursed per month (0.6% of employed people), and around 32,000 subsidies for full-time work paid (4.2% of employed people). In the manufacturing sector, enterprises in the manufacture of ICT and electrical appliances and the manufacture of metals made the most extensive use of the two subsidy schemes. As the Partial Subsidising of Full-

Time Work Act does not define criteria tying assistance to difficulties related to the crisis, subsidies were also granted to numerous enterprises from activities where difficulties may not have been entirely due to the crisis. A particularly large share of enterprises taking part in the subsidy schemes has also been observed in transport and storage activities, due to the participation of employees of Slovenske železnice, which also received various subsidies in previous years and where difficulties only aggravated in 2009. Labour-market policy is thus faced with the great challenge of increasing employment opportunities for workers included in the subsidy schemes after the expiry of the emergency acts.

***The economic crisis has not been sufficiently used for developing new skills in workers on temporary layoff.***

The extent to which "non-working" time was used for training and education was modest. Moreover, the contents of training programs are questionable and may not contribute to an individual's employability, given that most enterprises offered internal training carried out only by in-house mentors. As already pointed out during the adoption of the Partial Subsidising of Full-Time Work Act (see Economic Issues 2009, IMAD), leaving the responsibility for education and training of workers entirely to the employer, without support by expert institutions, may not be the best solution in terms of using the crisis as an opportunity to develop new skills.

## APPENDIX

Table P.1: Movement of the gross wage per employee by activity for 2007–2010, y-o-y growth in %

	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
<b>PRIVATE SECTOR TOTAL</b>	<b>8.2</b>	<b>9.4</b>	<b>9.3</b>	<b>5.0</b>	<b>2.8</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>	<b>5.0</b>
A Agriculture, forestry and fishing	10.2	9.3	10.8	6.6	1.2	1.6	-0.5	-2.9	3.3
B Mining	9.4	13.8	16.0	14.8	5.6	2.4	1.6	-4.9	3.4
C Manufacturing	8.2	9.7	9.4	3.4	0.0	-0.5	0.4	3.6	10.1
D Electricity, gas, steam and air conditioning supply	9.3	10.1	9.8	8.7	7.9	7.8	5.1	-3.1	4.7
E Water supply	8.3	9.1	9.1	5.2	4.2	3.2	1.2	0.0	2.7
F Construction	7.7	9.6	9.1	4.3	1.2	1.0	1.6	0.9	2.8
G Wholesale and retail trade	7.5	9.0	8.8	6.1	4.4	2.3	1.2	0.1	2.6
H Transportation and storage	8.7	8.5	10.4	6.6	2.3	2.1	0.5	-1.4	1.1
I Accommodation and food service activities	9.3	9.6	10.0	4.9	3.4	1.7	0.6	1.0	2.8
J Information and communication	6.8	7.8	8.7	6.2	3.7	3.1	0.8	-1.6	1.1
K Financial and insurance activities	8.7	8.8	8.2	-0.1	2.0	-3.8	0.3	-0.5	1.2
L Real estate activities	6.8	8.6	5.3	3.6	1.6	0.0	1.8	4.5	2.6
M Professional, scientific and technical activities	9.7	8.6	9.1	6.4	4.0	3.3	1.5	0.0	1.6
N Administrative and support service activities	8.6	11.4	10.2	8.0	6.6	2.1	-0.2	-0.6	2.5
S Other service activities	6.6	8.6	8.5	8.8	4.1	1.0	0.7	-0.1	3.2
<b>PUBLIC SECTOR TOTAL</b>	<b>7.0</b>	<b>6.9</b>	<b>11.8</b>	<b>13.3</b>	<b>12.0</b>	<b>11.4</b>	<b>2.8</b>	<b>0.8</b>	<b>-0.6</b>
O Public administration, defence, social security	11.1	10.8	13.2	13.7	11.5	9.8	2.5	0.5	-1.9
P Education	5.5	5.8	7.7	9.0	6.9	6.1	1.2	0.5	0.2
Q Health care and social assistance	5.5	4.3	16.8	21.1	21.4	22.6	5.5	1.4	-0.4
R Culture, leisure and recreation activities	2.4	5.8	8.3	5.0	6.9	5.7	2.2	0.9	0.7

Source: SORS, calculations by IMAD.

Table P.2: Number of minimum-wage earners before and after the minimum wage (MW) increase, by activity

	2009 average				March 2010				March 2010/2009	
	No. of empl., total (1)	No. of empl. with MW (2)	Share, in % 3=2/1	Distribution of empl. with MW, in %	No. of empl., total (1)	No. of empl. with MW (2)	Share, in % 3=2/1	Distribution of empl. with MW, in %	Increase in the share within act., in p.p.	Increase of the share in the total number of empl. with MW, in p.p.
<b>TOTAL</b>	<b>636,037</b>	<b>19,030</b>	<b>3.0</b>	<b>100.0</b>	<b>620,532</b>	<b>43,323</b>	<b>7.0</b>	<b>100.0</b>	<b>4.0</b>	<b>0.0</b>
A Agriculture, forestry and fishing	4,373	92	2.1	0.5	4,244	241	5.7	0.6	3.6	0.1
B Mining	3,088	4	0.1	0.0	2,777	18	0.6	0.0	0.5	0.0
C Manufacturing	167,962	6,669	4.0	35.0	160,977	11,519	7.2	26.6	3.2	-8.5
D Electricity, gas, steam and air conditioning supply	7,729	5	0.1	0.0	7,778	22	0.3	0.1	0.2	0.0
E Water supply	8,654	45	0.5	0.2	8,657	211	2.4	0.5	1.9	0.3
F Construction	45,013	2,490	5.5	13.1	39,664	4,710	11.9	10.9	6.3	-2.2
G Wholesale and retail trade	87,659	1,947	2.2	10.2	85,495	8,242	9.6	19.0	7.4	8.8
H Transportation and storage	35,307	744	2.1	3.9	33,930	1,396	4.1	3.2	2.0	-0.7
I Accommodation and food service activities	16,744	920	5.5	4.8	16,195	2,613	16.1	6.0	10.6	1.2
J Information and communication	19,153	149	0.8	0.8	18,784	375	2.0	0.9	1.2	0.1
K Financial and insurance activities	22,172	123	0.6	0.6	21,694	305	1.4	0.7	0.9	0.1
L Real estate activities	3,368	117	3.5	0.6	3,333	251	7.5	0.6	4.1	0.0
M Professional, scientific and technical activities	29,205	829	2.8	4.4	29,815	1,941	6.5	4.5	3.7	0.1
N Administrative and support service activities	20,153	4,027	20.0	21.2	20,367	6,413	31.5	14.8	11.5	-6.4
O Public administration, defence, social security	49,235	160	0.3	0.8	49,649	741	1.5	1.7	1.2	0.9
P Education	56,529	110	0.2	0.6	57,421	1,911	3.3	4.4	3.1	3.8
Q Health care and social assistance	45,451	181	0.4	1.0	45,631	1,490	3.3	3.4	2.9	2.5
R Culture, leisure and recreation activities	9,615	100	1.0	0.5	9,566	250	2.6	0.6	1.6	0.1
S Other service activities	4,630	318	6.9	1.7	4,555	674	14.8	1.6	7.9	-0.1

Source: AJPES.

**Table P.3: Index of wage level in the public sector (L, M, N) to wage level in the private sector (C–K), 2006  
(average wage in private-sector activities C–K = 100)**

Country		Total	6	5B	5A	3 and 4	2	0 and 1
Czech Rep.	L	108.0	109.7	78.8	68.8	111.5	83.5	89.1
	M	91.2	112.9	85.2	54.7	81.1	65.4	77.7
	N	92.1	112.8	76.7	77.5	90.2	83.4	84.8
Germany	L							
	M	113.0		66.0	69.4	85.4	97.7	
	N	90.8		63.0	89.7	86.7	94.6	
Ireland	L	117.5	116.3	104.5	113.0	119.9	125.2	123.7
	M	129.8	111.0	99.5	109.9	83.8	80.4	97.3
	N	111.6	112.5	102.1	109.2	99.4	90.5	91.1
Spain	L							
	M	115.1	76.3	93.5	80.9	83.5	98.4	85.0
	N	113.2	132.7	93.4	98.6	79.4	93.3	103.8
Cyprus	L	138.6			116.0	148.0		107.4
	M	161.5			101.4	77.0		73.3
	N	127.9			108.2	103.1		100.1
Hungary	L	134.9		113.3	92.3	131.9	131.8	133.5
	M	111.4		60.7	59.0	91.3	98.3	100.9
	N	92.9		79.9	66.8	97.0	103.2	106.1
Netherland	L	101.7		79.2	85.1	94.3	100.9	105.4
	M	101.6		79.2	74.7	84.8	83.9	88.7
	N	87.2		67.4	74.2	82.1	85.4	89.0
Poland	L	122.4	76.4	74.1	67.1	111.5	95.5	90.0
	M	100.1	55.3	57.8	57.1	78.9	73.7	74.0
	N	80.2	60.9	58.4	58.2	77.4	73.5	73.6
Slovenia	L	128.4		85.2	89.3	104.5	100.2	84.4
	M	138.5		100.3	76.1	111.5	88.6	85.8
	N	122.0		89.5	113.2	105.9	95.3	92.6
Slovakia	L	95.1	86.5	81.6	65.8	91.7	72.9	
	M	79.0	70.8	67.9	49.0	75.9	74.4	
	N	78.7	85.5	73.7	71.0	76.3	80.9	
U. K.	L	92.8		81.3	79.3	96.6	106.0	
	M	96.0		81.6	86.3	87.1	93.1	
	N	96.6		79.9	87.7	95.2	96.2	

Source: EUROSTAT, SES 2006, SCA 2002, calculations by IMAD.

Notes: L – Public administration, M – Education, N – Health and social work, Levels of education and training (ISCED 1997)

0 and 1 Pre-primary education and primary education or first stage of basic education, levels 0 and 1 (ISCED 1997)

2 Lower-secondary education or second stage of basic education, level 2 (ISCED 1997)

3 and 4 (Upper) secondary education and post-secondary non tertiary education, levels 3 and 4 (ISCED 1997)

5A First stage of tertiary education with programmes that are largely theoretically based, level 5A (ISCED 1997)

5B First stage of tertiary education with programmes that are practically oriented/occupationally specific, level 5B (ISCED 1997)

6 Second stage of tertiary education, level 6 (ISCED 1997)

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# **Part III**

## **Impact of the financial crisis on the credit market in Slovenia**



## Summary

**At the onset of the financial crisis, the situation on financial markets changed considerably.** To repay their existing liabilities, given the very limited availability of new financing sources, financial institutions sharpened their lending terms and reduced their lending activity. Banks restricted access to loans even to those enterprises that were willing to accept less favourable borrowing terms. On the other hand, there was a significant shift in the demand for loans. Household demand decreased in all segments, while the structure of demand by enterprises and NFI changed considerably. The latter asked for more working capital loans, mainly as a consequence of lower incomes due to decreased demand and lack of payment discipline, whereas demand for investment loans and loans to finance increased production fell. Restricted accessibility of financing sources and the liquidity problems of enterprises had a negative impact on the stability of the financial system. The quality of bank assets began to gradually deteriorate, and the banking sector was forced to create additional impairments, which all negatively affected banking-sector results.

**Along with the expansion of the financial crisis, lending activity began to slow down both in Slovenia and in other euro-area countries.** This slowdown was more explicit among enterprises and NFIs that mainly net repaid their loans, while the slowdown in household borrowing was somewhat less pronounced and this type of borrowing even began to see slightly stronger growth at the end of last year.

**In the past, the intense lending activity of the Slovenian banking system was mainly financed through borrowing abroad.** Between 2005 and 2008, banks took up foreign loans in the net amount of approximately EUR 12 bn. With the worsening of conditions on international interbank markets, the accessibility of these sources shrank significantly, and banks recorded a net outflow of foreign loans and deposits of over EUR 3 bn in 2009 alone. Thus, they became more dependent on other sources of financing provided by central banks through non-standard measures, whereas in Slovenia a greater role was assumed by (mainly long-term) government deposits and state guarantees. Funds for government deposits were acquired through additional borrowing on international financial markets. In terms of the maturity structure of financial sources, greater importance was also attached to long-term household deposits, mainly as a result of their migration from short-term deposits, since net flows of household deposits into banks in the past year recorded a decrease, which, according to our estimates, was due to worsening conditions on the labour market and more favourable trends on certain capital markets.

**Active interest rates in Slovenia are above the euro-area average.** The largest disparities are observed in interest rates for corporate borrowing, where the level is among the highest in the EMU. It is estimated that the reasons for such disparities lie in both supply and demand. Differences in interest rates for household borrowing were considerably less evident, while passive interest rates in Slovenia exceeded the average EMU value. Major differences were recorded in long-term deposits, probably owing to the deteriorating situation on international financial markets and the consequent lower accessibility of foreign long-term financing sources.

**Slovenian enterprises and NFIs are among the most indebted in the euro area, since other forms of financing are rather limited given the poorly developed Slovenian financial system.** The share of loans thus nearly equals the share of equity capital. The structure of liabilities reveals a lower share of liabilities in the form of shares and other securities, and an above-average share of short-term loans. On the other hand, enterprises and NFIs record a relatively small share of financial assets relative to liabilities. Compared with other euro-area countries, enterprises and NFIs in Slovenia mainly lack more liquid sources, such as currency and bank deposits, as well as securities other than shares. At the same time, Slovenian enterprises and NFI record a share of other liabilities that is above the euro-area average, mainly on account of trade credits and advances. The current situation in the economy, i.e. the lack of payment discipline and extended payment terms, creates additional pressures on the liquidity of enterprises and NFIs, which increasingly depend on external financing sources.

**The expansion of the financial crisis to other sectors of the economy also caused a worsening of the quality of bank investments.** The amount of bad and non-performing loans thus began to increase at a relatively high pace and banks responded by creating additional impairments, which affected their business results. The main risk is corporate and NFI borrowing, mainly activities related to investments into real estate and those involved in takeover activities. Amid negative trends on the labour market, household borrowing also represents a risk, but this risk is slightly lower, by our estimate. In the period of intense lending activity households mainly borrowed in the form of housing loans, a large part of which were taken up in Swiss francs. Negative trends are also expected

to continue in 2010 – based on data relating to the first quarter of the year, the volume of non-performing debts increased by approximately one tenth.

***Considering the strong dependence of the Slovenian economy on bank financing, structural changes in the manner of financing should also be taken into account.*** A very important part of this is short-term sources, causing increased pressures on corporate liquidity. Therefore, a more stable financial structure calls for redirection toward securities (mainly for larger enterprises) and direct investments. In the short term, liquidity could be improved through better payment discipline and mutual offsetting of claims.

## Introduction

**At the onset of the financial crisis, the situation on financial markets changed considerably.** To repay their existing liabilities and given the very limited availability of new financing sources, financial institutions sharpened their lending terms<sup>1</sup> and reduced their lending activity. Banks restricted access to loans even to those enterprises that were willing to accept less favourable borrowing terms. On the other hand, there was a significant shift in demand for loans. Household demand decreased in all segments, while the structure of demand by enterprises and NFIs changed considerably. The latter requested more working capital loans, mainly as a consequence of lower incomes due to decreased demand and lack of payment discipline, whereas demand for investment loans and loans to finance increased production fell. The restricted accessibility of financing sources and liquidity concerns of enterprises had a negative impact on the stability of the financial system. Quality of bank assets began to gradually deteriorate, and the banking sector was forced to create additional impairments, which all negatively affected bank results.

**This part of Economic Issues focuses on trends related to credit markets, since credits are one of the main sources of financing for the Slovenian economy.** Section one deals with past and present trends on credit markets in Slovenia and in the euro area. Section two provides a detailed analysis of the financial assets and liabilities of Slovenian enterprises and NFIs based on data from financial accounts. With the relatively high growth of non-performing loans in 2009, section three analyses risks to the stability of the banking system, while the last section provides findings and recommendations.

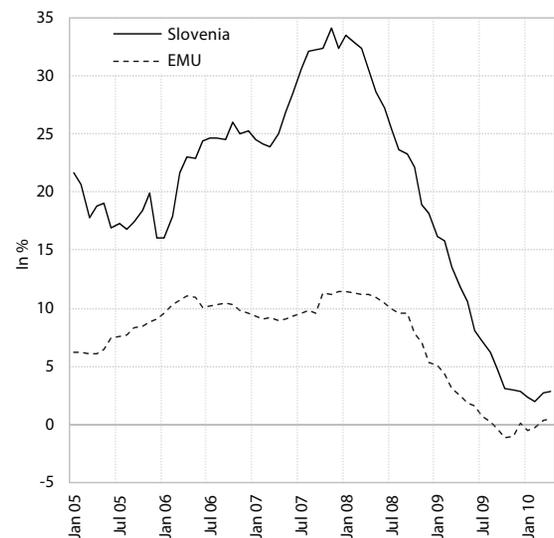
## 1. Lending activity

### 1. 1. Lending activity prior to the onset of the international financial crisis

**In a period of high economic growth, Slovenia and other EMU countries recorded intense lending activity.** Although the ECB gradually increased its main interest rate until mid 2008, when it reached 4.25%,<sup>2</sup> this had no significant influence on the growth of lending activity. The latter even strengthened in 2006 and 2007. In the EMU, growth was much below the level observed in Slovenia, which is mainly due to a more developed financial system also allowing other forms of financing. Between 2004 and 2009, the share of loans in Slovenia's GDP rose from over half to 93.7% of GDP,<sup>3</sup> thus reaching over 70% of the average value of this indicator in the EMU. The volume of loans to enterprises and NFIs totalled 67.1% of GDP and slightly exceeded the EMU average. The GDP share of household borrowing was significantly lower, and at 24.1% reached just over two fifths of the EMU value.

**In a period of high lending growth, in both Slovenia and the EMU, the fastest rise was observed in corporate and NFI borrowing, while household borrowing recorded relatively stable growth in Slovenia and a downward trend in the EMU.** With the

Figure 1: Year-on-year growth rates of bank loans to non-banking sectors in Slovenia and in the EMU



Source: ECB, BS; calculations by IMAD.

<sup>1</sup> The tightening of lending terms slowed in the last quarter of 2009, yet the share of banks sharpening their lending terms still exceeded the share of those that mitigated them. A similar trend is expected for the first half of 2010.

<sup>2</sup> Which was 225 basis points more than at the end of 2005 – prior to the launch of a restrictive monetary policy.

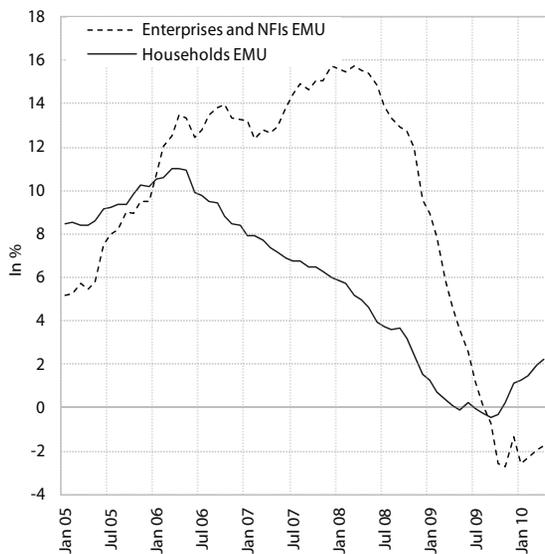
<sup>3</sup> In 2009, the value of this indicator grew mainly because of decreasing GDP.

onset of the international financial crisis, the pattern of lending activity in Slovenia and the EMU average were rather similar. Corporate borrowing slowed considerably in both cases, while Slovenia recorded a slightly smaller slowdown in household borrowing.

### 1.1.1. Lending activity in the EMU

**In a period of favourable economic trends, in the EMU, the highest increase was seen in the growth of loans to enterprises and NFIs.** These accounted for about half of all bank loans to non-banking sectors, while household borrowing (just over 40% of all loans) had been slowing since the second half of 2006, i.e. approximately two years before borrowing by enterprises and NFIs, which at the time were still making increased use of loans to enhance their investment activity and finance growing production volume.

Figure 2: Year-on-year growth rates of bank loans to enterprises and NFIs and to households in the EMU

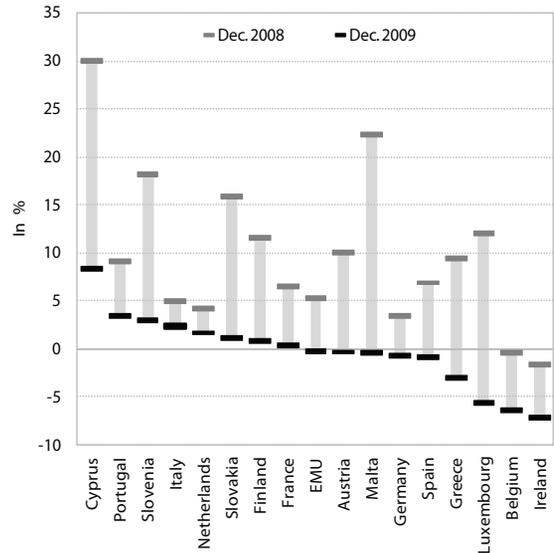


Source: ECB; calculations by IMAD.

#### **In the euro area, lending activity in 2009 was weak.**

On a year-on-year basis, loans recorded a 0.1% fall. In the previous year, non-banking sectors repaid bank loans in a net amount of EUR 12.2 bn. The greatest contribution to this trend was made by net repayment of loans by enterprises and NFIs of over EUR 100 bn (loans recorded a 1.7% year-on-year decrease). On the other hand, net household borrowing totalled EUR 54.9 bn, which was just over a quarter less than in 2008.

Figure 3: Year-on-year growth of loans to non-banking sectors in EMU countries



Source: ECB, BS; calculations by IMAD.

**Lending activity in EMU countries strengthened over the first four months of 2010, mainly owing to relatively high general-government net borrowing in March.** In this period, in fact, net flows were EUR 45.9 bn, recording the highest value within the last nine months, with a significant contribution made by general government borrowing, which in March totalled EUR 24.0 bn. In the first four months of the year, total net flows were EUR 70.8 m, which is approximately three times as much as in the comparable period in 2009, yet still considerably below the level observed prior to the outbreak of the financial crisis. This increase was mainly due to increased net general government and household borrowing, while the net flow of loans to enterprises and NFIs was still below the comparable level in 2009. On a year-on-year basis, the decline in corporate and NFI loans slightly increased.

## 1.2. Lending activity in Slovenia

#### **After a continuous rise following Slovenia's accession to the EU, lending activity reached a peak in 2007.**

The growth of loans of domestic non-banking sectors exceeded growth in the euro area by approximately threetimes. Slovenia's credit market was in fact relatively weak, also due to past monetary policy, which was oriented towards exchange-rate movements. Banks invested a considerable portion of assets into the securities of the Bank of Slovenia, which released into the banking sector approximately EUR 3.5 bn,<sup>4</sup> partly

<sup>4</sup> When the tolar was still in use, the Bank of Slovenia, to control the depreciation of the exchange rate, intervened in the

intended to finance intense lending activity. In addition, foreign sources of finance were then still very accessible and banks were also able to obtain the additional funds necessary to finance the intense lending activity under favourable terms on foreign interbank markets. In 2007, the net flow of domestic bank loans to domestic non-banking sectors achieved a figure of EUR 6.5 bn, which was nearly a fifth of GDP in that year. In the time of intense economic growth, demand for loans was high. Enterprises requested working capital loans for financing expanded production as well as investment loans given that capacity utilisation in this period was rather high. Favourable movements on capital markets also encouraged takeover activities that were largely financed through bank loans. High borrowing growth rates were also recorded by households, which predominantly took out housing loans, but also showed growing interest in consumption loans and loans for financing investments on capital markets.

**The structure of financing sources changed considerably after the outbreak of the financial crisis.** Between 2005 and 2008, banks took out foreign loans and deposits in the net amount of almost EUR 12 bn. At the end of 2008, however, financing on interbank markets came to a nearly complete halt. Thus, in 2009, banks repaid foreign loans and deposits in the net amount of over EUR 3 bn. They made up these amounts by borrowing from the central bank, while the government also provided additional deposits and government-guaranteed loans.<sup>5</sup> By the end of the year, liabilities to the Bank of Slovenia grew by almost EUR 1 bn, and an even stronger role was played by government deposits, which in 2009 more than doubled. The government obtained the necessary funds through three issues of bonds totalling EUR 4.0 bn, a considerable portion of which<sup>6</sup> was intended for bank deposits. Most financing was intended for long-term deposits, which improved the maturity structure of bank deposits. An additional contribution to this improvement was made by the high growth of long-term household savings, mainly resulting from slightly higher interest rates offered by banks for long-term deposits, as well as from renewed trust in the banking system encouraged by the government through unlimited guarantees for

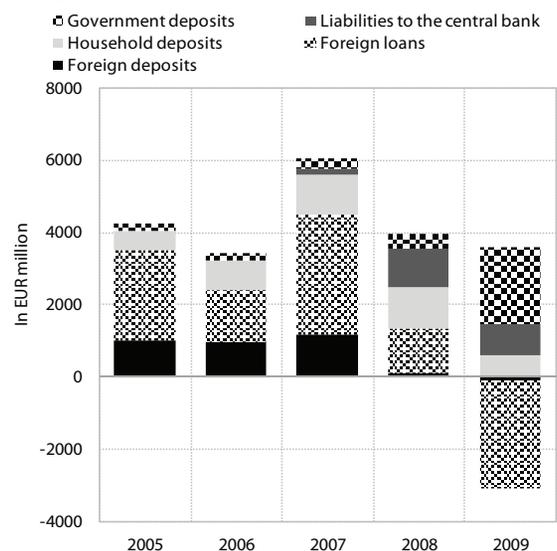
foreign-exchange market by purchasing foreign currencies and thus increased the volume of domestic currency, which the Bank of Slovenia later sterilised through the issue of bills. Upon Slovenia's accession to the EMU, monetary policy fell under the competence of the ECB and the bills due were no longer replaced by new bills, which increased the liquidity of the Slovenian banking system.

<sup>5</sup> In 2009, banks issued government-guaranteed bonds twice, in the total amount of EUR 2 bn, which slightly improved the maturity structure of bank resources.

<sup>6</sup> Net inflows of government deposits achieved the level of EUR 2.1 bn.

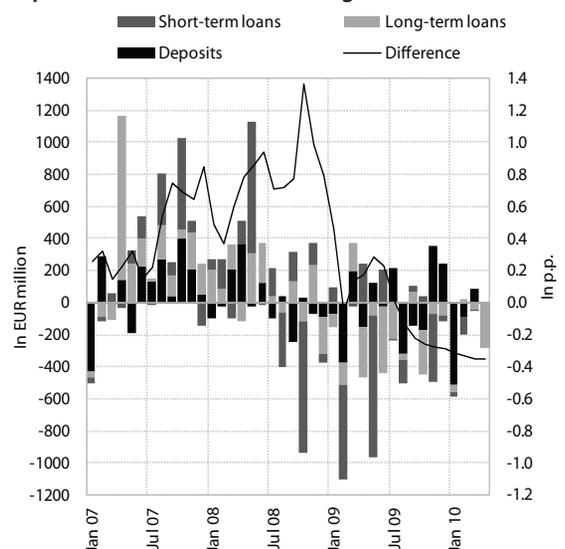
deposits by natural persons and small enterprises. In 2009, the accelerated growth of long-term household deposits was mainly fed by short-term deposits, since interest rates for the latter continued to fall while net inflows of household deposits into banks (EUR 624.0 bn) were almost 50% lower than in the previous year. This was a consequence of unfavourable movements on the labour market and of the partly higher basis resulting from high net inflows from capital markets in 2008.

**Figure 4: Annual net flows of foreign loans and deposits, household deposits, borrowing from the central bank, and government deposits**



Source: BS; calculations by IMAD.

**Figure 5: Difference between 3M EURIBOR and ECB central interest rate, and net flows of foreign loans and deposits in the Slovenian banking sector**



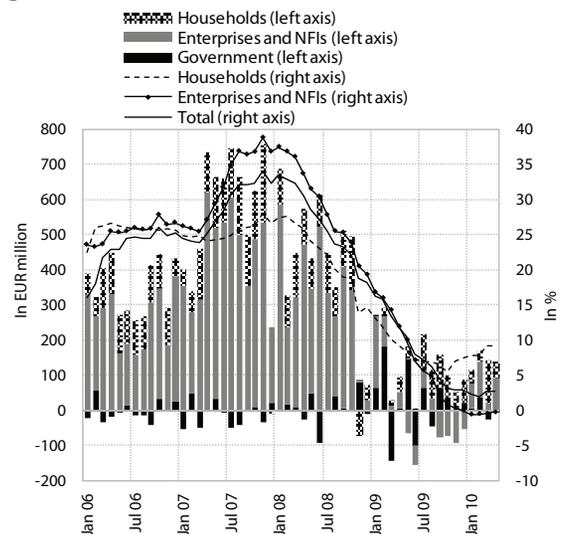
Source: BS, www.euribor.org; calculations by IMAD.

**The conditions on international financial markets tightened no earlier than in 2008.** In fact, prior to the outbreak of the international financial crisis in the second half of 2007, no major aggravation was observed. Interest rates did rise slightly and the maturity of financial sources began to shorten. Interbank markets only froze in September 2008 following the collapse of Lehman Brothers. Interest rates rose strongly, but later began to gradually decrease, thanks to the ECB's expansionary monetary policy, although the availability of resources was very modest.

**In 2009, banks recorded net lending to non-banking sectors in the amount of EUR 895.9 m (less than a fifth of the level posted in 2008), almost two thirds of which was attributable to net household borrowing.** This sizeable decline was mainly due to significantly lower net borrowing by enterprises and NFIs, reaching only 0.6% of the value recorded in 2008. The deceleration of the year-on-year growth rate in loans to domestic non-banking sectors slowed considerably at the end of the year, with growth reaching 2.8%. This trend was attributable exclusively to the nearly 5% growth in the volume of euro loans, although their net flows were almost 70% lower than in 2008, while the volume of foreign-currency loans shrank by more than one fifth as a consequence of higher currency risk, while banks responded to the unstable situation on foreign-exchange markets with higher spreads on foreign-currency loans.

**Compared with previous years, this year and last year, household demand for loans was decreasing as expected.** From over 26% at the end of 2007, year-on-year growth dropped to 14.8% at the end of 2008 and 7.5% at the end of 2009. Net flows of household loans amounted to EUR 586.0 m, which was over 40% less than in the year before. A solid 90% (EUR 531.8 m) of total net household borrowing was made up of borrowing in the form of housing loans, which was approximately one quarter lower than in the year before. The demand for consumer loans continued to decline, with just over a tenth of the 2008 value (EUR 16 m) being raised. Following the intense borrowing activity observed in previous years when, thanks to favourable conditions, households mainly raised foreign-currency loans, the end of 2008 saw a structural shift, which also continued in 2009. According to IMAD's estimates, given the high risk related to the change in the exchange rate, households transformed a part of the foreign-currency loans into euro loans. Thus, despite the aggravation of borrowing terms, net flows of euro loans in 2009 amounted to EUR 760.9 m and were more than a quarter higher than in the year before.

Figure 6: Net flows and year-on-year growth rates of loans to households, enterprises and NFIs, and the government



Source: Bank of Slovenia; calculations by IMAD.

**Net flows of corporate and NFI borrowing in 2009 were positive, although very low, while further significant decline was, according to IMAD's estimates, prevented by the guarantee scheme for enterprises.<sup>7</sup>** Net flows were thus only EUR 23.6 m, which is the lowest level since comparable data have been available.<sup>8</sup> On a year-on-year basis, the total volume of loans increased by 0.1%. Enterprises raised loans only for investments (EUR 306.4 m), with net flows achieving less than a quarter of the 2008 level. Considering that in the same month net inflows of investment loans were covered by a similarly high net repayment of working capital loans, we estimate that both enterprises and NFIs in general merely restructured the maturity of their loans. In fact, in the period of intense lending activity, great importance was also attached to short-term loans raised by enterprises to finance long-term projects, given that short-term loans helped the banks to bring in line the maturity structure of their balance sheets, while enterprises expected those loans to be easily refinanced when falling due; at the same time, shorter maturity also offered more favourable interest rates. Corporate and NFI borrowing was also modest abroad, although, at EUR 69.4 m, exceeded net borrowing from domestic banks; nevertheless, it was almost 90% lower than in the previous year. The reason for such a significant decline lies mainly in net repayment of loans in December 2009 in the amount of EUR 319.4 m – the highest value ever recorded.

<sup>7</sup> According to data, the drawdown of loans based on the guarantee scheme reached EUR 645 m by the end of the first quarter of the current year.

<sup>8</sup> Since 2005.

**In the first four months of 2010, banks' lending activity strengthened compared with previous years, while the decline in year-on-year growth rates slowed down.** Net flows thus amounted to EUR 523.5 m and were a solid 3% lower than in the comparable period of 2009. The strongest rise was seen in household borrowing, mainly housing loans, which were more than 100% higher than in the same period last year. Corporate and NFI borrowing was almost a fifth lower than in the comparable period last year. Greater shifts were observed in the structure of loans by purpose. Thus, enterprises and NFIs increased borrowing in the form of working capital loans, recording a net flow of over EUR 345 m, which was slightly above the value recorded for the comparable period last year. According to our estimates, this increase was – contrary to the situation last year – largely due to the refinancing of investment loans due, since this recorded a net outflow in the amount of over EUR 190 m. Thus, enterprises replaced their long-term investment loans with loans of shorter maturity, which is expected to additionally increase pressure on their liquidity. Corporate borrowing abroad is slowing, with net flows in the first four months of the year reaching only EUR 29.6 m (just over a quarter of the 2009 value). This decline results from lower net borrowing in the form of long-term loans, while short-term loans repayment was slightly below the level recorded in the same period last year.

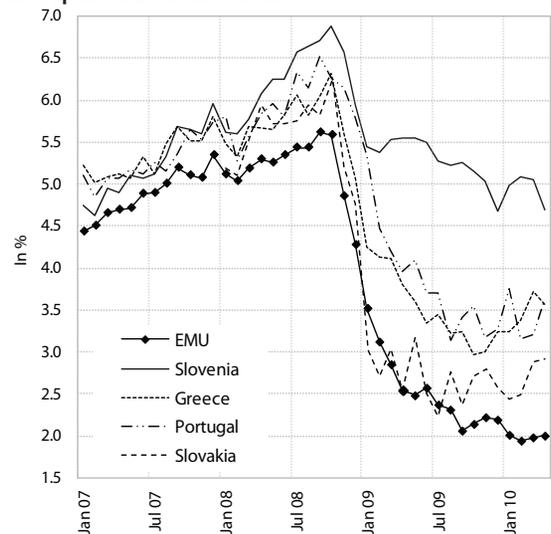
### 1.1.3. Interest rates

**Active interest rates for Slovenian enterprises are relatively high and thus represent an additional burden.** They differ from the EMU average by more than 250 basis points<sup>9</sup> and in April reached one of the highest levels among all Member States.<sup>10</sup> Their level did not fully follow the downward trend of the ECB central interest rate or the movements of interest rates in other euro-area countries. Estimates show that Slovenian banks responded to the worsening of the financial crisis by raising credit standards even more than the banks in other EMU countries on average (see Financial Stability Review, 2010). The only other countries that deviated from the EMU average by over 100 basis points were Malta, Cyprus, Greece and Portugal. In April, these countries recorded a rate of return on maturity of long-term government bonds that was at least 24 basis points higher than Slovenia, while the rate on return on Slovenians government bonds in the same month was approximately 26 basis points higher than the euro-area average. Nevertheless, in most of the above-mentioned countries, interest rates for corporate borrowing were

<sup>9</sup> Interest rates for enterprises in case of loans exceeding EUR 1 m with a variable or up to one-year fixed interest rate.

<sup>10</sup> A higher interest rate was recorded only by Cyprus.

Figure 7: Interest rates for corporate loans in Slovenia and specific EMU countries



Source: BS, ECB.

significantly lower than in Slovenia, which means that country risk is currently only a minor aspect in determining interest rates for corporate loans.

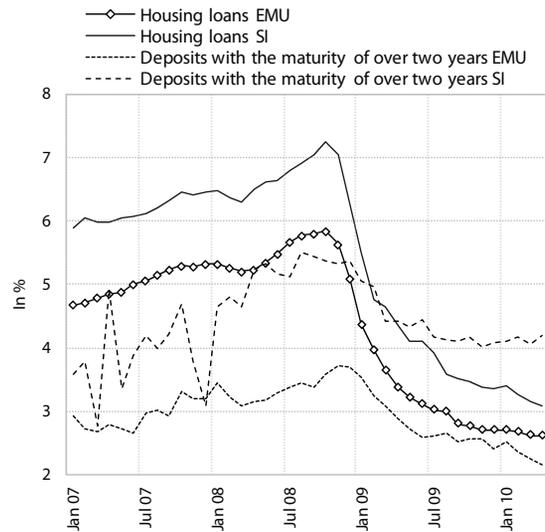
**There are multiple reasons for the higher credit interest rates to Slovenian non-financial corporations.** (i) In recent years, banks granted significant loans for construction and takeover activities. These were also the activities most severely hit by the crisis. The quality of banks' assets thus began to gradually deteriorate, and the banks started to cover for the losses and the burdens of additional impairment by raising margins. (ii) One major reason could lie in the manner of financing past lending activity by banks. Owing to the limited availability of domestic sources, which failed to follow the increased lending activity, banks largely financed their activity through foreign loans, which usually have shorter maturity than other sources of finance (issuing bonds and obtaining additional capital). Thus, banks themselves were forced to offer loans with shorter maturity. Enterprises thus financed long-term projects through short-maturity borrowing, at the same time expecting that loans due would be replaced with new loans. The financial crisis, however, strongly deteriorated conditions on credit markets, giving banks an additional lever to increase interest rates. (iii) Another possible reason for the high interest rates is the market structure of the banking system, which is among the most concentrated in the euro area<sup>11</sup>

<sup>11</sup> The Herfindahl index in 2008 was 1,268, while the EMU average (Slovakia excluded) was 687. This high value was partly a result of the small scale of the Slovenian banking system, although a number of comparable countries recorded an even lower value of the Herfindahl index.

(see Structural Indicators for the EU Banking Sector). (iv) Banks report, in particular, a lack of projects of adequate quality that could be financed with lower interest rates, compared with other countries in the euro area.

**On the other hand, other interest rates presented smaller disparities.** As regards household credits, interest rates were just slightly higher than the average euro-area value. The relatively unfavourable situation on interbank markets, however, points to differences in passive interest rates since Slovenian banks – to increase the inflow of long-term household borrowing – offer long-term loans with interest rates that are between 100 and 200 basis points higher than the euro-area average (see also page 79).

Figure 8: Interest rates for housing loans and deposits with maturity above two years



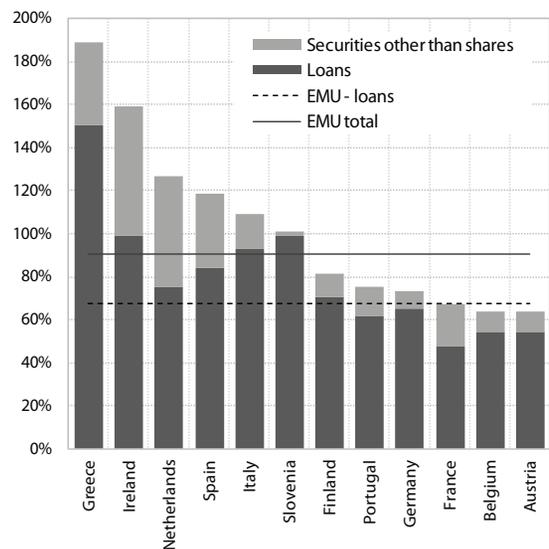
Source: BS, ECB.

## 2. Financial liabilities and assets of Slovenian enterprises and NFIs

### 2.1. Financial liabilities of enterprises and NFIs

**The financial system in the euro area is bank oriented, but there are considerable disparities among individual member countries both in terms of development and in operation of financial systems.** In Slovenia, virtually the sole possible external source of financing is borrowing from banks, which was a major factor in past economic growth. Borrowing based on the issue of debt securities and gathering of capital through issue of equity shares or other ownership entry into enterprises was rather insignificant in the past. Compared with other EMU countries, the share of loans<sup>12</sup> in equity capital was almost one half larger than the EMU average, reaching 98.8% in 2008.<sup>13</sup> Among the EMU countries for which data are available, a higher volume of loans as a share of equity capital was recorded only by Greece and, on a comparable level with Slovenia, Ireland. The relatively high share of corporate and NFI loans in equity in Slovenia is also a consequence of poorly developed financial market as there are practically

Figure 9: Volume of corporate and NFI loans and securities other than shares compared with equity at the end of 2008



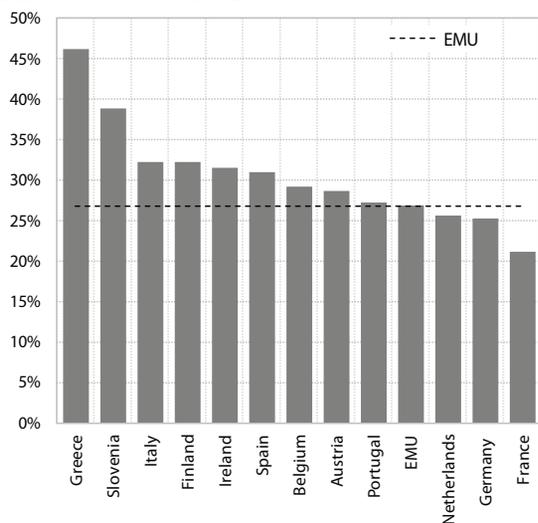
Source: Eurostat; calculations by IMAD.

<sup>12</sup> Commercial loans and advances excluded.

<sup>13</sup> This share did not change considerably in 2009.

no other possibilities for debt financing. Compared with 2007, this indicator for Slovenia increased by 34.1 p.p.,<sup>14</sup> mainly owing to relatively intense lending activity and a significant drop in the value of quoted shares, which resulted in a smaller volume of equity.

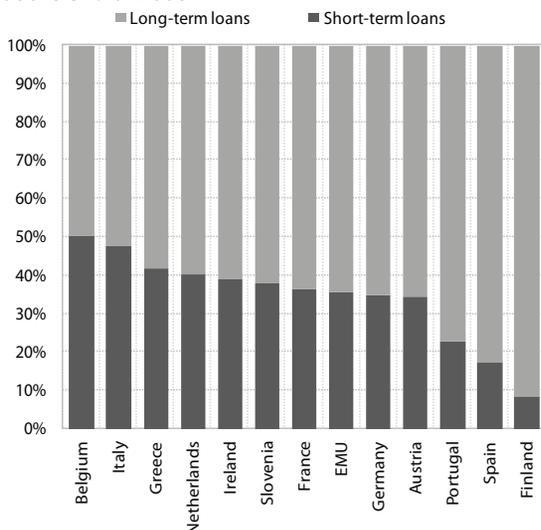
Figure 10: Loans as a share of corporate and NFI liabilities at the end of 2008



Source: Eurostat; calculations by IMAD.

**There are also considerable discrepancies as regards the maturity structure of loans.** At the end of 2008, the proportion of short-term loans for Slovenian enterprises and NFIs was 38.0%, which was only slightly above the EMU average,<sup>15</sup> where this share

Figure 11: Maturity structure of corporate and NFI loans at the end of 2008



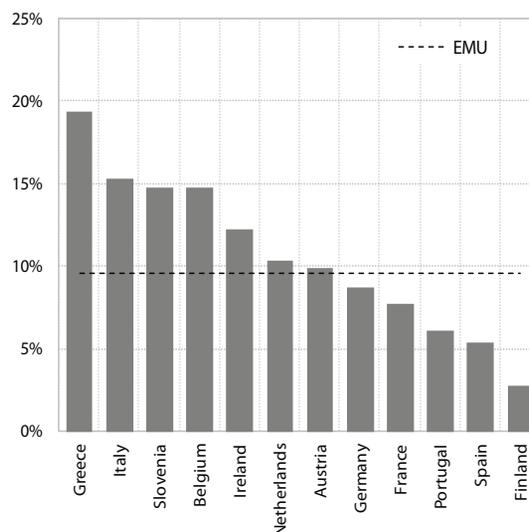
Source: Eurostat; calculations by IMAD.

<sup>14</sup> In the EMU, the value rose by over 20 p.p.

<sup>15</sup> No data available for Malta, Cyprus, Luxembourg and Slovakia.

was approximately 35%.<sup>16</sup> Owing to the larger share of loans in liabilities compared with most other euro-area countries, short-term loans accounted for less than 15% of all liabilities, which was over 50% more than the average EMU value.

Figure 12: Short-term loans as % of liabilities at the end of 2008



Source: Eurostat; calculations by IMAD.

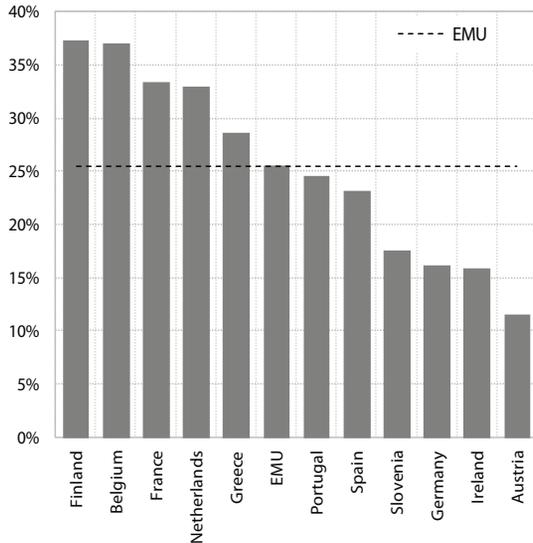
**Slovenian enterprises and NFIs have a relatively smaller share of liabilities in long-term instruments,<sup>17</sup> which in a time of aggravated conditions results in additional pressures on liquidity.** The share of equity in liabilities in Slovenia does not deviate significantly from the EMU average, although a more detailed comparison shows a relatively low volume of shares, which in our estimation derives from the small and poorly developed capital market, since businesses rarely obtain equity by issuing shares (see Mastnak, 2010), while most Slovenian businesses are too small to efficiently issue securities on more developed capital markets. The gap between Slovenian enterprises and NFIs and those in euro-area countries is even larger as regards financing based on securities other than shares. On average in the EMU, this accounted for about a tenth of liabilities, while in Slovenia it accounted for less than 1%. The market capitalisation of corporate and NFI bonds listed on the Ljubljana stock exchange at the end of 2009 amounted to EUR 453.4 m, which is only 4.2% of the total market capitalisation of bonds and 2% of the value of the loans that these enterprises and NFIs raised from domestic banks. According to our estimate, a significant step

<sup>16</sup> Owing to debt restructuring, 2009 saw a significant drop in the share of short-term loans, which thus accounted for only a solid third of all loans, which was the lowest value since 2006.

<sup>17</sup> Mainly in shares and other securities.

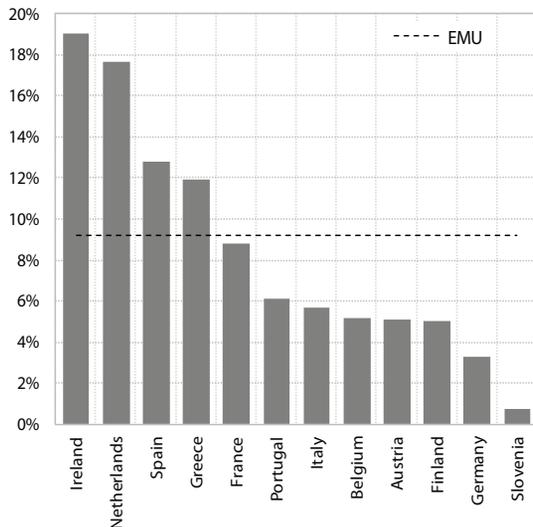
forward in this segment could be the pension reform which, by attaching more importance to the second pension pillar,<sup>18</sup> will enhance demand for relatively safe and liquid investments.

Figure 13: Shares as % of liabilities at the end of 2008



Source: Eurostat; calculations by IMAD.

Figure 14: Securities other than shares as % of corporate and NFI liabilities at the end of 2008



Source: Eurostat; calculations by IMAD.

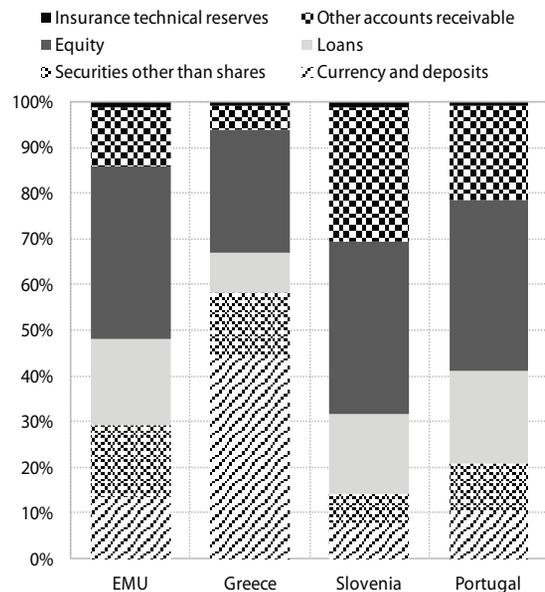
<sup>18</sup> Important investments of pension funds include corporate bonds. Regular monthly inflow into pension funds could strengthen the domestic demand for such securities.

## 2.2. Financial assets of enterprises and NFIs

**Slovenian enterprises and NFIs have a relatively low volume of financial assets<sup>19</sup> compared with liabilities, and are therefore more dependent on external financing.** The share of financial assets in the liabilities of Slovenian enterprises and NFIs is less than 60% whereas in the EMU it is almost 80%. In 2008, Slovenia recorded a large share of other accounts receivable, which was almost 30%, twice as high as the EMU average. In this segment of financial liabilities, the largest share is held by trade credits, meaning that Slovenian enterprises have claims on buyers (trade credits and advances) which exceed the average, reaching almost 30% of all financial assets. This share did not increase in 2009, which is surprising given the reported extension of payment deadlines and lack of payment discipline. This is probably due to a lower volume of corporate and NFI operations. Given that the amount of other liabilities exceeds the EMU average, however, we believe that liquidity pressures on enterprises also derive from less favourable payment terms and insufficient payment discipline.

**The financial assets of Slovenian enterprises and NFIs are also less liquid than the EMU average and therefore more dependent on external sources of financing.** Thus a minor role among financial assets is played by currency and deposits (8.1%), while the EMU

Figure 15: Structure of financial assets in Slovenia, EMU and selected EMU member countries in 2008



Source: Eurostat; calculations by IMAD.

<sup>19</sup> Currency and deposits, securities other than shares, equity, insurance technical reserves, loans, other accounts receivable.

average in 2008 was about one half higher. Slovenian enterprises and NFIs also record a relatively small share of securities other than shares, which amount to slightly more than 6% of all financial assets, while in the EMU this share exceeds 15%. These indicators show that the share of liquid assets in Slovenian enterprises and NFIs is considerably below the EMU average, which means that Slovenian enterprises are even more dependent on external sources of financing, and their operations are more sensitive to liquidity crunches.

### 3. Risks to the financial system

***Compared with certain other countries in the euro area, the banking system in Slovenia has not yet experienced any major shocks and remains stable despite the accelerated growth of non-performing loans.*** Slovenian banks encountered problems later than the banks with more developed financial systems, which represent a significant part of the EMU banking system. This delay was primarily due to the fact that Slovenian banks had not been highly exposed to investments related to sub-prime mortgage securities, and uncertainty entered the Slovenian banking system mainly because of the secondary effects of lower liquidity on international financial markets and because of the expansion of unfavourable trends to other economic sectors. Initially, the negative effects of the international financial crisis reflected in slightly more limited availability of resources, and only at a later stage did it also begin to affect the quality of bank investments and, consequently, business results. Risk factors related to the stability of the Slovenian financial system may be divided into two groups, i.e. external and internal risk factors.

#### 3.1. External risk factors

***After governments and central banks adopted non-standard measures to cope with the financial crisis and provide additional liquidity to the banking system, it is expected that this year some of the adopted measures will gradually be phased out.*** The ECB anticipated that it would cancel the operations of long-term refinancing through which it provided in 2009 for practically unlimited liquidity with one-year maturity.<sup>20</sup> Moreover, state measures have only limited duration and the state is preparing certain measures to replace part of the measures expiring on 31 December 2010.<sup>21</sup> Banks will therefore be forced to

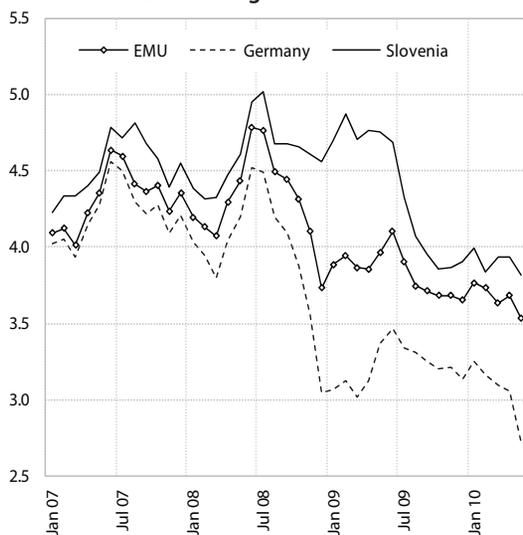
<sup>20</sup> However, in worsening conditions due to the increasing crisis in Greece, the ECB strengthened three- and six-month operations of long-term refinancing.

<sup>21</sup> At the beginning of May, the government adopted a draft act on guarantees of the Republic of Slovenia for financing investments of companies. The purpose of this draft act is to enable companies with a registered seat in Slovenia to take up long-term loans for financing investments intended to increase value added per employee or to increase employment. The unlimited guarantees for deposits will expiry at the end of 2010, when the amount of unlimited guarantees will be raised – in accordance with Directive 2009/19/EC adopted in March 2009 – to EUR 100,000, which is almost five times more than the amount of guarantees prior to the outbreak of the financial crisis. At the same time, the directive provides that the deadline for the payment of guaranteed deposits be reduced from 3 months to 20 working days.

find additional resources on interbank markets, which will increase demand and reduce the availability of external sources of financing, particularly for minor, less established banks. Long-term financing based on the issue of bonds, in which central government borrowing also plays a significant role, could become more important for Slovenian banks than in the past (compared with interbank loans).<sup>22</sup>

**The conditions under which banks will be able to take up loans on international financial markets will largely depend on credit assessment and borrowing terms applicable to the countries of origin.** Although a comparison of yield to maturity of government bonds shows that Slovenia's lag behind the EMU average is relatively narrow and comparable to periods preceding the international financial and economic crisis, a slightly more detailed comparison among euro-area states reveals that the gap to the countries with the lowest risk assessment has increased considerably. Thus, in April the required yield of Slovenian bonds was 88 basis points higher than in Germany, which is approximately three times as much as prior to the crisis.

Figure 16: Yields to maturity of Slovenian and German bonds and the EMU average



Source: Eurostat.

### 3.2. Internal risk factors

**At the onset of the financial crisis, the major risks to the stability of the Slovenian financial system were external factors, although internal factors**

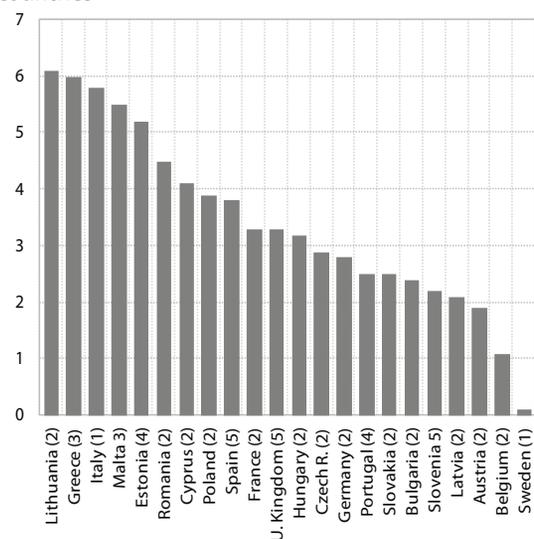
<sup>22</sup> Given that the need for additional financing and the consequent pressures on financial markets increased considerably in the last few months, the ECB had already intervened on the markets of government and private-sector debt securities.

**have acquired considerable importance with the progress of the crisis.** Internal factors are related to the intense lending activity of enterprises and NFIs in the past years, and to high exposure to activities that were most severely hit by the crisis; a slightly lower but still significant risk is household borrowing, mainly in terms of trends on the labour and foreign-currency markets.

#### 3.2.1. Growth of bad and non-performing debts

**Along with the accessibility of funds on international financial markets, Slovenian banks also face problems related to their past lending activity.** Studies indicate that in the past, bank crises were also a result of the high growth of loans (see e.g. Demirgüç-Kunt, Detragiache, 1997). At its peak, loan growth in Slovenia was approximately three times higher than the EMU average and also strongly exceeded economic growth. Thus, loans as a share of GDP over the past few years have increased considerably. At the end of the year, the total of non-performing loans (loans with ratings D and E) was EUR 1.1 bn, which is about 30% more than at the end of 2008. In the same period, the share of non-performing debts increased by 0.4 p.p. and reached 2.2%. Despite a relatively high growth, the share of non-performing loans still remains considerably below the level recorded in 2008 by certain other EU Member States. Even higher growth was observed among loans with rating C, which, together with non-performing loans, make up a group of bad loans in the total amount of EUR

Figure 17: Share of non-performing loans in selected countries



Source: IMF.

Notes: (1) Q4 2007; (2) Q4 2008; (3) Q2 2009; (4) Q3 2009; (5) Q4 2009.

1.3 bn at the end of the year, which was by a factor of 1.7 higher than in the previous year. It is estimated that part of the loans with rating C will be reclassified in the future in categories D in E, which will maintain the growth of non-performing loans at a relatively elevated level.

**After the intense lending activity in the years following Slovenia's accession to the EMU, last year saw an increase in the share of non-performing loans as a result of the deteriorated conditions in the economy.** Their share rose for the first time in the three years for which comparable data are available. The highest increase was recorded by activities that had previously been more exposed to takeovers and investments into real estate. Enterprises from such activities were in fact among those entities that had been most affected by the outbreak of the economic crisis. The deteriorating quality of bank assets reflected in creating additional impairments that had already increased by the end of 2008, and in 2009 reached close to EUR 500 m, an almost two-thirds increase compared with the previous year. The intense creation of additional impairments continued in the first four months of 2010. In this period, banks recorded additional impairments and reservations in the amount of EUR 147.8 m, which is an increase of over one third on the same period in the previous year. In the first two months of 2010, the volume of non-performing loans rose by a solid 2% and accounted for 2.3% of assets of the Slovenian banking system. Conversely, C-rated loans recorded a similarly high decrease, which according to our estimates derives from the transposition of loans of this kind into non-performing loans.

### 3.2.2. Risks in corporate and NFI borrowing

**In the period of fastest loan growth (2006 to 2008), a significant share of borrowing was intended for activities related to construction and takeovers.**<sup>23</sup> The amount of loans to such sectors then increased by EUR 4.4 bn. These activities were most affected by the onset of the international financial crisis: construction due to the decrease in real-estate selling and the consequent lack of cash flow to repay all their liabilities; and enterprises engaged in takeover activities due to reduced operations<sup>24</sup> and a significant drop in the value of their property as a result of negative trends

<sup>23</sup> The activities include financial intermediation, real estate, and scientific and technical activities.

<sup>24</sup> Their credits were not intended to expand production and create new value added, which additionally burdened the already existing production activities.

on financial markets.<sup>25</sup> The quality of bank claims to these sectors deteriorated considerably in 2009. The share of non-performing loans to such sectors on average rose by over 1.6 p.p.<sup>26</sup>

**A relatively high share of non-performing loans was also recorded in manufacturing.**<sup>27</sup> The latter accounts for about a quarter of all bank loans to non-financial enterprises: its share of non-performing loans exceeded one third of all non-performing loans to non-financial enterprises, while 3.4% of all domestic bank loans extended to this sector featured among non-performing debts.

**Enterprises and NFIs have a relatively large share of short-term loans, which accounted for about 35% of all loans.** Enterprises and NFIs financed a large portion of their long-term projects through short-term loans to refinance them with new loans upon maturity. This form of financing was also encouraged by banks, which, given the shorter maturity terms on the interbank markets, had to provide for a coherent maturity structure in their own balance sheets. The situation on financial markets, however, changed considerably and banks were either no longer willing to refinance the loans due or imposed much stricter terms, which represented an additional burden to corporate cash flows. In 2008,<sup>28</sup> almost half of corporate borrowing from domestic banks was short-term loans, which represented an additional risk for the quality of balance sheets in the Slovenian banking system.

### 3.2.3. Risks in household borrowing

**The risks to financial stability in the household sector mainly derive from a lack of capacity to repay loans, which is related to income movements.**<sup>29</sup> The current situation of high unemployment and reduced incomes (also in relative terms compared with the amount of instalment or loan) could lead to some households no longer being able to repay their loans. After last year's decrease, in 2010, the number of salary recipients is expected (IMAD's Spring Forecast) to drop by a further 2.3%, meaning that the average

<sup>25</sup> In 2008, the central index of the Ljubljana stock exchange SBI20 recorded a decrease of 67.5%.

<sup>26</sup> This is four times more than the annual increase of non-performing loans.

<sup>27</sup> Given its share in GDP, manufacturing is the most important sector of the Slovenian economy since, despite a significant decrease, its value added in 2009 still accounted for the largest share of GDP (17.5%).

<sup>28</sup> Until 2008, detailed data from Financial Accounts are available.

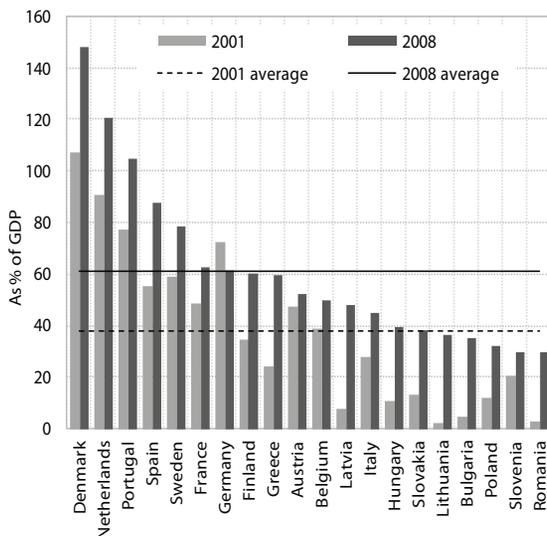
<sup>29</sup> To a slightly lesser extent, also due to trends in foreign-exchange markets.

annual number of unemployed people will rise by about 22% and the net salary mass will decrease in real terms by a solid 1%.

**In aggregate terms, Slovenian households are less indebted than those in the EU.** Since there are no available data on annual instalments, delayed amounts, etc., or the income structure of borrowers, and gathering data of this kind is not possible through the Slovenian Credit Bureau (SISBON), the data below<sup>30</sup> allow us only to assume the risk to the financial system deriving from household credit. According to the quarterly financial accounts of the Bank of Slovenia, at the end of 2009, household and NPISH liabilities were nominally higher by 5.4%, which was the slowest growth since 2002 when annual data were available. For the first time since 2004, the amount of liabilities rose less than the amount of financial assets (8.0%). Indebtedness measured as the ratio between liabilities and financial assets thus slightly decreased compared with the previous year (by 0.8 p.p. to 29.6%). At the same time, indebtedness measured by liabilities as a share of GDP last year rose by 3.6 p.p. to 33.8% because of the significant fall in GDP.

**A quarter of all households find it difficult or very difficult to make ends meet, a share similar to the EU average.** According to the EU-SILC survey, in 2008 (latest data available only for the period prior to the worsening of the crisis), the share of those who

Figure 18: Share of liabilities in GDP, in %, households and NPISH, 2008 and 2001, EU



Source: Eurostat.

Notes: <sup>1</sup> European countries for which data are available – by simple average.

<sup>30</sup> Household borrowing at aggregate level, survey data on credit burden, delays and household capacities to meet liabilities based on data on debt rating.

find it difficult or very difficult to make ends meet was similar to the EU average and slightly above the EMU average, while a similar share was recorded by households in arrears on hire-purchase instalments or payments of non-housing loans (2–3%). A total of 67% of Slovenian households reported not having to pay any instalments.

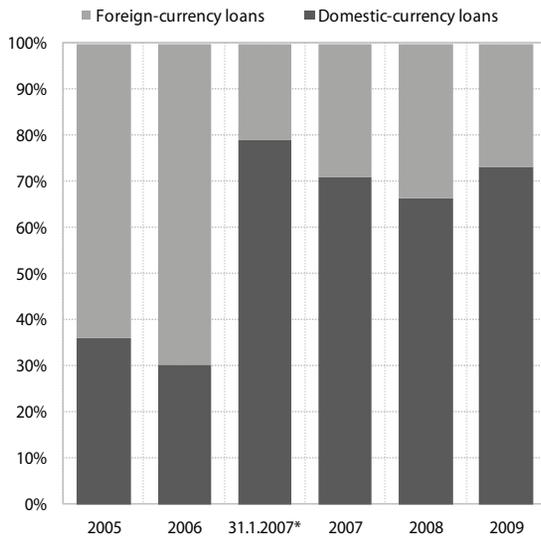
**The risk of non-payment is greater in housing loans as the latter involve higher values and their maturity is longer, which means that there is a much higher probability of households' income status changing in the meantime, or of this status affecting their repayment capacity.** The share of housing loans in the total structure of household loans has heavily increased since 2004, when it accounted for 23.3% (rising to 46.7% at the end of 2009, 47.8% in March 2010), but this was still below the EMU average (71.6% at the end of 2009). This is also one of the reasons for the relatively lower aggregate indebtedness of Slovenian households (see Figure 18), as consumer loans with shorter maturity expire sooner and accumulate less. The increased risk of housing loans also reflects in the relevant borrowing dynamics. Between 2005 and 2009, housing loans recorded net flows in the amount of EUR 3.1 bn and represented almost two thirds of the total net borrowing of households from banks, with their volume increasing over this period nearly four times.<sup>31</sup> This means that most loans of this kind were taken in the last four years. Thus, it is estimated that the probability of difficulties in repayment was higher. More risky still are loans granted just before the outbreak of the crisis, when real-estate value was at its peak – there is, in fact, the chance that if unfavourable trends on the real-estate market continue, the value of these loans due will exceed the market value of the pledged property.

**In addition to heavy borrowing in the form of housing loans, exchange rate risks present an additional risk since most foreign-currency household loans are in fact housing loans.**<sup>32</sup> Given more favourable borrowing terms, the accelerated growth of foreign-currency housing loans continued even after the introduction of the euro, with their share increasing from a solid fifth to a little less than 35% before the worsening of the financial crisis in the last quarter of 2008. According to our estimates, with the occurrence of the credit crunch and great uncertainty on foreign exchange markets, some borrowers later decided to transform their foreign-currency loans into euro loans, so the share of the first dropped to a solid quarter of the previous level by March 2010, although their value was still relatively high, amounting to EUR 1.1 bn.

<sup>31</sup> Growth in the EMU was less than 40%.

<sup>32</sup> The share exceeds 80%.

Figure 19: Currency structure of housing loans between 2005 and 2009



Source: BS, calculations by IMAD.

Note: \* This great structural shift is a result of the introduction of the euro on 1 January 2007.

## 4. Findings and challenges

**With the onset of the financial crisis, lending activity began to slow in every country of the euro area, although at rather different pace.** The heaviest falls in year-on-year loan growth rates were observed in countries that only a year before had recorded above-average growth in loans to domestic non-banking sectors. Among individual sectors of the economy, the most significant slowdown was observed in corporate and NFI borrowing; in 2009, enterprises and NFIs net repaid their loans, while household borrowing was only a quarter less than the year before.

**Slovenia is one of the countries that recorded an evident slowdown in the growth of loans to domestic non-banking sectors, but nevertheless retained one of the highest growth rates in the euro area.** This growth was a result of the smaller decrease in household borrowing and the still modest positive net flow of corporate and NFI borrowing. Despite a more pronounced deterioration of lending terms than in the rest of the euro area, enterprises and NFIs still borrowed from domestic banks, recording a minimum year-on-year growth rate that was among the highest in the euro area. We have assessed that the continued willingness of enterprises to borrow despite unfavourable lending terms is a result of the smaller volume of their own financial assets, which are also less liquid, and of the relatively large volume of liabilities, including the important share of short-term liabilities that lead enterprises and NFIs into even greater dependence on borrowing from banks, which in Slovenia is practically the only possible source of external financing.

**In 2009, there was a more rapid deterioration of the quality of bank assets.** Given the rather intense lending activity in the recent past, this deterioration was partly expected, yet an important contribution to the growing share of non-performing and bad loans was also made by the outbreak of the financial crisis. A considerable share of loans was granted in a time of high economic growth, when risks were less obvious and banks acted in a very pro-cyclical manner; in fact, in times of positive economic prospects, the level of attention paid to risk assessment is rather low (which additionally strengthens lending activity), while in a time of economic slowdown banks are too restrictive (which further enhances negative trends). The volume of non-performing loans thus rose by slightly less than 30%, but was still below the level recorded by certain other EU countries, and below the level within the banking system at the time of EU accession.

***In terms of non-performing and bad debts, high growth rates are recorded in particular by activities related to investment into real estate and those involved in takeovers. By our estimates, enterprises and NFIs repaid part of the loans they were unable to repay with new loans, thereby postponing the increase of non-performing and bad debts. Risks on the side of households*** are much lower and seem to exist only in relation to borrowing in the form of housing loans, which in past years was very strong. The currency structure of these loans is also risky, since a considerable part is made up of foreign-currency loans.

***Particular attention must be paid to the existing trends in quality of bank investments and to the low lending activity of domestic banks.*** Data regarding the introduction of additional impairments in the first two months of 2010 show that the quality of investments of the Slovenian banking system continues to deteriorate, while the share of non-performing loans has risen to 2.3%. Should the growth of non-performing and bad loans continue, it would be wise to consider adopting additional measures to manage risks and rehabilitate bad assets. Lending activity has slightly improved compared with the end of 2009, but remains at a rather low level. Problems with low lending activity are also faced by enterprises that have not been significantly hit by the crisis, or even see it as an opportunity. Easier access to financial sources would thus make operations easier and prevent the crisis from spreading to enterprises without structural problems, which would also mitigate pressures on financial stability.

***Over a longer period of time, it would be wise to consider structural changes in the way in which the Slovenian economy is financed.*** Much of the economy is financed through borrowing from banks. The problem of such financing is that (i) loans have shorter maturity, and (ii) that sooner or later they need to be repaid. The financial crisis only accelerated this process. Therefore, to provide for a more stable financial structure, attention must be redirected to securities (shares, and also bonds that have longer maturity than loans) and direct investments. In the short term, liquidity could be improved through better payment discipline and mutual offsetting of claims.

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