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I. Fiscal developments and fiscal policy

Summary

In 2011 deficits in EU countries narrowed significantly for the first time since 2009, and the consolidation process continued in 2012, albeit at a slower pace. As the economic crisis continues, the majority of EU countries are still subject to excessive deficit procedures; eight have so far been granted extensions for the correction of the deficit, while it was recommended this year that the procedure be terminated for the four countries that have managed to reduce their deficits below 3% of GDP. Five euro area countries whose situation deteriorated sharply and that were shut out of financial markets have so far requested financial assistance. Average growth in general government debt in the EU and the euro area has slowed in recent years following a significant acceleration in 2009, with the widening of the debt-to-GDP ratio increasingly driven by interest expenditure, expenditure not associated with the coverage of the primary deficit, and changes in nominal GDP. On top of the measures that directly increased debt, in the past few years many EU countries issued extensive guarantees under existing state aid rules, which has increased the contingent liabilities that will be realised if the guarantees are called. The yields on the government bonds of the most vulnerable euro area countries spiked in the aftermath of the Cyprus crisis in March this year, and they remain relatively high. The spreads over the German benchmark bond vary significantly, having already widened in mid-2012 amidst speculation that the euro area might break up or split into two tiers.

In the last two years crucial steps were taken to strengthen economic governance and fiscal policy surveillance and coordination in the EU. Following the implementation of five regulations and one directive that are binding on the entire EU, and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the fiscal compact), which is binding on euro area countries and introduced a balanced-budget rule, two additional regulations were adopted in March 2013 (the two-pack), which set out in detail the implementation of the fiscal provisions of previous regulations.

Slovenia's general government deficit narrowed significantly last year (4% of GDP) as a result of fiscal consolidation measures, to its lowest level since the outbreak of the crisis in 2008. Last year's fiscal consolidation was largely underpinned by expenditure cuts; in contrast to previous years, a significant fiscal effort was made as expenditure was down in nominal terms for the first time, and declined as a share of GDP. For the first time since 2009 revenue also declined in nominal terms. The revenue dynamics were driven largely by the weakening of the economy, and partly by tax changes. In terms of quality, it is estimated that changes towards a more sustainable restructuring of expenditure were achieved in 2012. In contrast to previous years, fiscal consolidation measures were based to a greater extent on structural changes underpinned by legislative changes. This was reflected in a significantly lower structural component of the deficit, which fell for the first time since 2005. The structural deficit needs to be interpreted cautiously given its high volatility; nevertheless all recent estimates suggest that the structural position of Slovenia's public finances deteriorated significantly in 2008 and improved visibly in 2012. A slightly higher deficit in 2012 relative to the projections in the 2012 update to the Stability Programme (SP2012) was primarily the result of unbudgeted specific transactions in the amount of 0.4% of GDP, as well as expenditure structure, which was also different than planned.. Compensation of employees and intermediate government consumption were significantly above the levels projected in the SP2012, while expenditure on social benefits, interest, subsidies and investments was lower than forecast. Slovenia had one of the most pronounced reductions in the general government deficit in the EU in 2012, but it was still below the average in the EU and the euro area in terms of cuts relative to 2009. This is particularly problematic given that Slovenia faces declining revenue against the backdrop of one of the deepest economic downturns in the EU, and it is one of the countries facing the greatest pressure on public finances due to an ageing population.

Slovenia's general government debt has been growing faster than in the majority of EU countries, and as in previous years, last year's increase was used to finance the deficit and roll over debt. General government debt was estimated at 54.1% of GDP at the end of 2012, up 32.1 percentage points on 2008. Although Slovenia is still in the lower half of the EU in terms of the debt-to-GDP ratio, the increase in the last four years was the seventh largest in the EU. Throughout the entire period debt growth was driven by deficit financing and borrowing to roll over debt. In 2009 and 2012, the debt-to-GDP ratio was also significantly affected by a nominal contraction in gross domestic product.

As overall debt continued to rise and the macroeconomic conditions deteriorated, borrowing costs rose significantly last year. Bond yields were affected by domestic factors as well as the general tightening of conditions on the Eurobond market mid-year. In September ECB measures in particular resulted in renewed optimism on European financial markets, contributing to a fall in the yield on 10-year Slovenian government bonds to about 5% at the end of the year. The yield surged again towards the end of March 2013, as increased uncertainty surrounding the resolution of the debt and banking crisis in Cyprus began driving up the borrowing costs of all vulnerable euro area countries, Slovenia in particular. In the first half of April the yield hovered at over 6.5%; it has since fallen, but remains relatively high. Rating agencies downgraded Slovenia's sovereign debt again: S&P and Fitch by one notch in May, and Moody's by two notches at the end of April (to speculative grade). The downgrades were prompted by the weakening of the banking system and the rising debt, but the agencies also highlighted uncertain economic growth prospects.

Fiscal consolidation as envisaged in the 2013 update to the Stability Programme (SP2013) has been slower than forecast last year. The departure from last year's projections is greatest in 2013, when the actual deficit is projected at 7.9% of GDP. One-off expenditure associated with bank recapitalisation and the restructuring of the banking system account for 3.7 GDP percentage points of the deficit. However, even if these specific transactions were excluded, the general government deficit would not narrow this year. Higher interest expenditure and expenditure on social benefits has coupled with significantly higher intermediate government expenditure. Despite additional measures to limit compensation of employees in the general government sector and significantly reduce expenditure on investments and subsidies, the nominal reduction in expenditure forecast last year will not be achieved this year, not least because it was not underpinned by specific measures. Moreover, the revenue projections for this year are also lower as a result of the weak economy, despite additional discretionary measures that will take effect in the middle of the year. Consolidation will also be slower than planned in the following years, due in large part to higher interest expenditure and higher-than-forecast investments.

In this year's Stability Programme higher taxation is a key component of consolidation, but that is sensible only as an auxiliary measure in an economic policy mix where structural measures to sustainably reduce expenditure must play the central role. This year's Stability Programme places much greater emphasis on revenue-side measures, which primarily increase the burden on consumption and can raise corporate costs if they do not entirely pass through into prices. Although the higher tax burden in indirect taxes will contribute to fiscal consolidation, it is sensible only as an auxiliary measure in an economic policy mix where measures to reduce expenditure must play the central role. It is important that curbing growth in or even reducing expenditure be achieved via structural changes, and only to a lesser extent via a contraction in investment activity and emergency measures that are not viable in the long term.

The SP2013 does not provide a comprehensive response to this challenge, which will require measures to be framed this year and in the coming years that have a sustainable impact and do not cause new imbalances. The discretionary expenditure-side measures specified in the SP2013, some of which are temporary, are focused on limiting compensation of employees and social transfers. In this context the top challenge of economic policy in the short term will be to put in place permanent expenditure-side measures to prevent the introduction of a crisis tax in 2014. The crisis tax would swing the deficit-reduction policy mix strongly to the revenue side. Not only is this a marked departure from the stated goals, it is also questionable what their actual impact would be given the weak economy and the strong contraction in private consumption expenditure. Fiscal consolidation faces the additional challenge of a sensible implementation of the balanced budget fiscal rule, which will be defined in an implementing law. Given the latest simulations of the fiscal rule, which do not envisage any extraordinary circumstances arising, this will require additional fiscal effort over the next two years.

Given the rapid growth in the general government debt this year and in previous years, partly as a result of the recapitalisation of banks and state-owned companies, fiscal consolidation coupled with a successful restructuring of the banking system is the key to maintaining the debt at a sustainable level. The general government debt and debt servicing costs have been rising, which has resulted in interest expenditure increasingly crowding out other expenditure and creating a negative feedback loop. In addition to this expenditure and the financing of the primary balance, which will be balanced after 2014 according to Stability Programme projections, the one-off rise in debt this year will be the result of measures to restructure the banking system, which is vital to creating a more stable macroeconomic environment, kick-starting growth and improving Slovenia's standing on the financial markets. The planned government guarantees for the bond issue by the Bank Assets Management Company (BAMC) will increase debt by 11.4% of GDP, but the effect will be mitigated in subsequent years as

the transferred assets are sold off and liquidated. Yet even in the event of the entire project being successfully completed, the general government debt would rise to above 60% of GDP at the end of the programming period, and given lower proceeds from the sale of the assets transferred to the BAMC, it would approach 70% of GDP. Other downside risks to faster debt growth remain high. Given the widening differences between the more and less vulnerable euro area countries, bond yields to maturity may rise in a spill-over effect throughout the euro area that will affect Slovenia's borrowing costs. If the financial markets start doubting Slovenia's commitment to consolidation measures and bank restructuring, securing the requisite funds to finance the deficit and roll over debt would be rendered difficult or even impossible, casting doubt on the execution of other measures set out in this year's Stability Programme. Limited government access to financing would also affect the borrowing conditions of the private sector, which would have a further adverse impact on competitiveness and potential growth.

Introduction

After a substantial narrowing of the general government deficit in 2012, fiscal policy and other economic policies face the challenge of pushing ahead with consolidation and honouring the commitments within the framework of the excessive deficit procedure. This May the European Commission recommended an extension for Slovenia, allowing it to bring its deficit below 3% of GDP not in 2013, but in 2015. This does not however mean that Slovenia can slow the pace of consolidation. Given the continued weakness of the economy and the high costs of restructuring the banking system, fiscal and other economic policy makers face an even greater challenge in how to carry out consolidation in a sustainable way and with minimum adverse impact on economic activity while still providing public services of sufficient quality. Coupled with the effective restructuring of the banking system, successful consolidation will stabilise the macroeconomic environment and make it easier for the government and companies to tap the financial markets.

The fiscal chapter of this year's report focuses on analysis of the public finances and an assessment of the fiscal consolidation as envisaged in the 2013 update to the Stability Programme. The first chapters present the developments in public finances in the EU and fiscal aggregates and trends in Slovenia, including an analysis of cyclical and structural factors, financial flows between Slovenia and the EU budget, public debt, and long-term fiscal sustainability in connection with the costs of the ageing population. This is followed by an overview of tax changes in Slovenia and the EU in recent years. The overview is followed by a critical review of fiscal consolidation in this year's Stability Programme, and finally based on all the analysis there is an examination of the challenges for fiscal policy in achieving the set objectives in a manner that will help strengthen the development role of public finances.

1. Fiscal Developments and Fiscal Policy in the EU

In the majority of EU countries the general government deficit narrowed sharply in 2011, and the consolidation process continued in 2012, albeit at a slower pace. Deficits surged in 2009 due to the impact of the economic and financial crisis and stimulus measures, and remained roughly at the same level in 2010, but in 2011 they narrowed significantly, by 2 percentage points in the euro area and 2.1 percentage points in the EU overall. Measures geared towards streamlining expenditure were the driving force of consolidation, but several countries also adopted revenue-side measures. Measures to reduce expenditure include curbs on the public sector, and curbs on social transfers and pensions. The majority of EU countries thus froze or cut employment in the public sector, whereas countries with bigger fiscal problems also cut the wages of civil servants. On the revenue side, many countries changed tax legislation with a view to increasing the taxation of consumption[1] and

Table 1: **Actual and cyclically adjusted general government balances in EU countries [2]**

	Actual balance (as % of GDP)						Structural balance (as % of GDP)					
	2008	2009	2010	2011	2012	2013	2008	2009	2010	2011	2012	2013
Belgium	-1.0	-5.6	-3.8	-3.7	*-3.9*	*-2.9*	-2.1	-3.9	-3.4	-3.5	*-3.0*	*-2.3*
Germany	-0.1	-3.1	-4.1	-0.8	*0.2*	*-0.2*	-0.9	-0.8	-2.3	-0.9	*0.3*	*0.4*
Estonia	-2.9	-2.0	0.2	1.2	*-0.3*	*-0.3*	-4.5	-1.1	-1.1	-0.6	*0.2*	*-0.2*
Ireland	-7.4	-13.9	-30.8	-13.4	*-7.6*	*-7.5*	-7.6	-9.8	-9.1	-7.7	*-7.4*	*-6.9*
Greece	-9.8	-15.6	-10.7	-9.5	*-10.0*	*-3.8*	-9.6	-14.8	-8.8	-5.4	*-1.0*	*2.0*
Spain	-4.5	-11.2	-9.7	-9.4	*-10.6*	*-6.5*	-4.5	-8.5	-7.4	-7.2	*-5.5*	*-4.4*
France	-3.3	-7.5	-7.1	-5.3	*-4.8*	*-3.9*	-4.2	-6.1	-5.8	-4.7	*-3.6*	*-2.2*
Italy	-2.7	-5.5	-4.5	-3.8	*-3.0*	*-2.9*	-3.8	-4.2	-3.7	-3.6	*-1.4*	*-0.5*
Cyprus	0.9	-6.1	-5.3	-6.3	*-6.3*	*-6.5*	-0.8	-6.5	-5.7	-6.6	*-6.7*	*-5.4*
Luxembourg	3.2	-0.8	-0.9	-0.2	*-0.8*	*-0.2*	2.7	1.0	-0.1	0.3	*0.1*	*0.7*
Malta	-4.6	-3.7	-3.6	-2.8	*-3.3*	*-3.7*	-6.2	-3.9	-4.6	-3.6	*-4.1*	*-3.8*
Netherlands	0.5	-5.6	-5.1	-4.5	*-4.1*	*-3.6*	-0.7	-4.1	-4.0	-3.7	*-2.6*	*-2.0*
Austria	-0.9	-4.1	-4.5	-2.5	*-2.5*	*-2.2*	-1.9	-2.7	-3.3	-2.2	*-1.5*	*-1.6*
Portugal	-3.6	-10.2	-9.8	-4.4	*-6.4*	*-5.5*	-4.5	-8.7	-8.8	-6.6	*-4.2*	*-3.6*
Slovenia*	-1.9	-6.2	-5.9	-6.4	*-4.0*	*-5.3*	-4.4	-4.4	-4.7	-4.7	*-2.7*	*-2.4*
Slovakia	-2.1	-8.0	-7.7	-5.1	*-4.3*	*-3.0*	-4.1	-7.2	-7.1	-5.2	*-4.1*	*-3.0*
Finland	4.4	-2.5	-2.5	-0.8	*-1.9*	*-1.8*	2.5	0.6	-0.7	-0.1	*-0.7*	*-0.6*
EMU-17	-2.1	-6.4	-6.2	-4.2	*-3.7*	*-2.9*	-3.0	-4.5	-4.5	-3.6	*-2.1*	*-1.4*
Bulgaria	1.7	-4.3	-3.1	-2.0	*-0.8*	*-1.3*	-0.2	-3.5	-2.1	-1.6	*-0.4*	*-0.8*
Czech Republic	-2.2	-5.8	-4.8	-3.3	*-4.4*	*-2.9*	-4.3	-5.4	-4.5	-3.0	*-1.7*	*-1.6*
Denmark	3.2	-2.7	-2.5	-1.8	*-4.0*	*-1.7*	2.3	0.2	-0.2	0.3	*0.3*	*0.0*
Latvia	-4.2	-9.8	-8.1	-3.6	*-1.2*	*-1.2*	-5.6	-5.5	-2.9	-1.6	*-0.3*	*-1.4*
Lithuania	-3.3	-9.4	-7.2	-5.5	*-3.2*	*-2.9*	-5.3	-6.6	-4.7	-4.9	*-3.2*	*-2.8*
Hungary	-3.7	-4.6	-4.3	4.3	*-1.9*	*-3.0*	-4.6	-2.3	-3.3	-4.1	*-0.7*	*-1.1*
Poland	-3.7	-7.4	-7.9	-5.0	*-3.9*	*-3.9*	-5.0	-8.2	-8.3	-5.4	*-3.8*	*-3.3*
Romania	-5.7	-9.0	-6.8	-5.6	*-2.9*	*-2.6*	-7.9	-9.5	-6.2	-4.0	*-2.7*	*-1.7*
Sweden	2.2	-0.7	0.3	0.2	*-0.5*	*-1.1*	1.5	2.7	1.3	0.2	*0.2*	*-0.1*
United Kingdom	-5.1	-11.5	-10.2	-7.8	*-6.3*	*-6.8*	-5.0	-9.4	-8.9	-6.8	*-7.0*	*-5.7*
EU-27	-2.4	-6.9	-6.5	-4.4	*-4.0*	*-3.4*	-3.2	-5.0	-4.9	-3.9	*-2.8*	*-2.0*

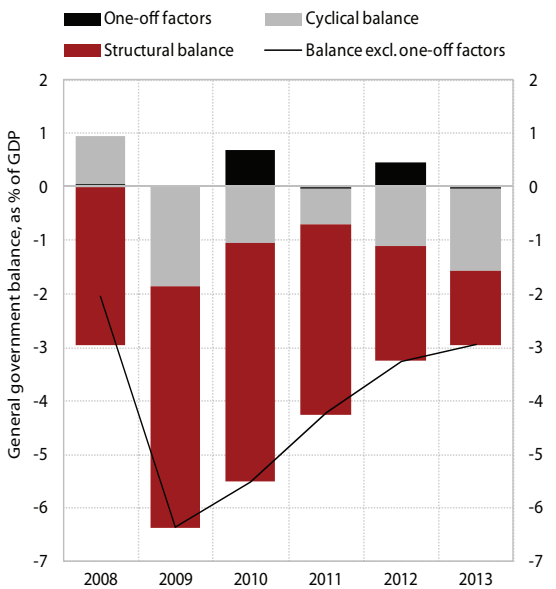
Source: Eurostat, European Commission Spring Economic Forecast 2013. Note: * European Commission forecast.

[1] Since the outbreak of the crisis in 2008, 17 EU countries have raised VAT rates (see Chapter 6); many have also raised excise duties on tobacco and alcohol (e.g. Slovakia, France, Ireland, Romania, UK), while several have introduced or increased the taxation of real estate (e.g. Austria, Slovakia, Cyprus, Italy).

[2] The European Commission forecast for the actual position for Slovenia in 2013 differs from the projections in the 2013 update to the Stability Programme on account of differing forecasts for one-off factors. The European Commission's forecast for the cyclically adjusted position for Slovenia also differs from the IMAD forecasts (see Chapter 2.1). The differences are to be expected (the calculation hinges on multiple assumptions and forecasts), mostly as a result of different estimates of the output gap (there are several differences in input data on the workforce in employment according to the national accounts statistics due to a break in the series, and in the estimate of capital; the calculation is also affected by differences in GDP forecasts and components) and certain methodological differences (NAWRU calculation).

property, and alleviating the burden on the economy. In the majority of countries short-term measures have been coupled with structural changes, aimed in particular at ensuring that age-related expenditure remains at a sustainable level. In 2012 the consolidation process continued in the euro area and the EU, but the deficit reduction was slower in relative terms than in the previous year (0.5 percentage points in the euro area and 0.4 percentage points in the EU). The estimates of structural and cyclical components (European Commission Spring Forecast 2013) show that the slowing of consolidation in 2012 was attributed primarily to a renewed weakening of the economic environment (a higher negative cyclical component) and a slightly more moderate positive contribution by fiscal policy measures than in 2011. A major factor in last year's slowing of consolidation was the deterioration in the public finances of certain EU countries with surpluses or very low deficits. In its Spring Forecast 2013, the European Commission is forecasting a further improvement in the public finances this year and next year in the euro area and the EU (by 0.8 percentage points and 0.6 percentage points respectively). In contrast to previous years, the deficit reduction will be underpinned to a larger extent by discretionary expenditure-side measures, and less so by revenue-side measures according to the European Commission assessment.

Figure 1: **General government balance in the euro area, as % of GDP**



Source: Eurostat, for 2013 EC Spring Economic Forecast 2013, Ameco.

As the economic crisis continues, the majority of EU countries remain subject to excessive deficit procedures,[3] and eight have so far been granted extensions for the correction of the deficit. In 2009 and 2010 excessive deficit procedures were initiated for 18 EU countries, bringing the total to 20 by 2010. The majority of countries were given until 2012 or 2013 to correct their excessive deficits. So far the procedures have been completed by four countries (Bulgaria, Finland, Malta and Germany) that had reduced their deficits to below 3% of GDP by 2011. Only half of the countries given until 2012 to correct their deficits realised this commitment, i.e. reduced their deficits to below 3% of GDP, with the European Commission Spring Forecast suggesting that some will probably still not comply this year. The EU Council has already granted extensions to four countries (Portugal, Spain, Ireland and Greece) where the economic circumstances changed significantly compared with the original forecasts in the recommendations for the correction of the deficit. Extensions were also granted this year to France, the Netherlands, Poland and Slovenia, while Spain and Portugal were given additional extensions. The termination of the excessive deficit procedure was meanwhile proposed for Italy, Latvia, Lithuania, Hungary and Romania.

Faced with financial difficulties, five euro area countries have so far asked the European Commission for financial assistance, which is carried out through several mechanisms, and three countries outside the euro area have requested balance of payments assistance. Access to aid from European financial mechanisms is conditional on strict implementation of policy measures based on a macroeconomic adjustment programme and a thorough analysis of the sustainability of government borrowing, which is carried out by the Commission and the IMF in liaison with the ECB. EFSF/ESM[4] financial assistance has so far been requested by five euro area countries (Greece, Ireland, Portugal, Cyprus and Spain, the last only for bank recapitalisation). Approval of the first tranche of aid is conditional on the signing of a Memorandum of Understanding in which the recipient country undertakes to carry out an economic policy programme. Approval of subsequent tranches requires approval by the donor

[3] Countries subject to the excessive deficit procedure provide regular progress reports to the European Commission on measures to consolidate their public finances. In the event of unforeseen economic circumstances that significantly diverge from the forecast in the recommendation for the correction of the excessive deficit, the deadline may be extended. Closer coordination of fiscal policies in the EU tightened the oversight of measures within the excessive deficit procedure, in particular in euro area countries. Countries that do not follow EU Council recommendations for the correction of the excessive deficit and adjustment to the medium-term fiscal target may even face sanctions under the new regulations and the fiscal compact.

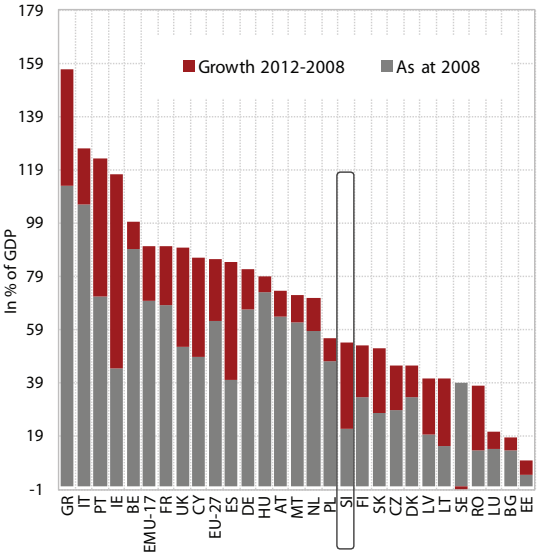
[4] EFSF: European Financial Stability Facility (due to be discontinued in mid-2013); ESM: European Stability Mechanism (in place since October 2012). For more on financial mechanisms, see also EI 2012, Chapter 1.

countries, which must confirm whether the recipient country meets the conditions from the economic policy programme, which is verified by the European Commission in conjunction with the ECB. Three countries outside the euro area (Romania, Hungary and Latvia) that had serious trouble in securing foreign financing to cover their balance of payments deficits have so far requested assistance via the balance of payments mechanism.

Average growth in the general government debt in the EU and the euro area has slowed in recent years following a significant acceleration in 2009, with the widening of the debt-to-GDP ratio increasingly driven by interest expenditure, stock-flow adjustment, and changes in nominal GDP. Since 2008 the average general government debt rose by 23.1 percentage points in the EU and 20.5 percentage points in the euro area. Debt growth peaked in 2009 (at 12.4 percentage points) and then slowed, but the pace remained significantly higher than before the crisis. In 2009 and 2010 in particular the surge in borrowing was primarily a consequence of high deficits and extra-budgetary expenditure targeted at securing the stability of the financial system as part of measures to tackle the crisis. In the last two years the contribution made by interest expenditure has been growing; in 2011 the contribution made by stock-flow adjustment[4] was also more pronounced, and in 2012 declining nominal GDP once again contributed to the increase. By contrast, the euro area's average primary balance was positive last year for the first time since 2008, and no longer contributed to widening debt. On top of the measures that directly increased debt, many EU countries last year issued extensive guarantees under the existing state aid rules, which have increased contingent liabilities that will be realised if the guarantees are actually called. Over the entire period the largest rises in the debt-to-GDP ratio in the euro area were recorded by Ireland, Portugal, Greece, Spain, Cyprus and Slovenia. The European Commission is forecasting a renewed increase in growth in debt this year, in the euro area as well as in the EU. The trend will be driven in particular by rising interest expenditure and partially by stock-flow adjustment, which includes differences between cash-based expenditure and expenditure according to the accrual principle, financial transactions and revaluation changes. The debt will also increase in relative terms as a result of the projected decline in GDP this year.

[5] Stock-flow adjustments comprise differences between cash-based expenditure and expenditure according to the accrual principle, financial transactions and revaluation changes. The differences in recent years stem largely from net acquisitions of financial assets that exceeded general government deficits and were mainly associated with recapitalisations and operations to support the financial sector and government-owned companies.

Figure 2: **General government debt increase in EU countries, 2008–2012**



Source: Eurostat.

Table 2: **General government debt, as % of GDP**

	2008	2009	2010	2011	2012	2013*
Belgium	89.2	95.7	95.5	97.8	*99.6*	*101.4*
Germany	66.8	74.5	82.4	80.4	*81.9*	*81.1*
Estonia	4.5	7.2	6.7	6.2	*10.1*	*10.2*
Ireland	44.5	64.8	92.1	106.4	*117.6*	*123.3*
Greece	112.9	129.7	148.3	170.3	*156.9*	*175.2*
Spain	40.2	53.9	61.5	69.3	*84.2*	*91.3*
France	68.2	79.2	82.4	85.8	*90.2*	*94.0*
Italy	106.1	116.4	119.3	120.8	*127.0*	*131.4*
Cyprus	48.9	58.5	61.3	71.1	*85.8*	*109.5*
Luxembourg	14.4	15.3	19.2	18.3	*20.8*	*23.4*
Malta	62.0	66.4	67.4	70.3	*72.1*	*73.9*
Netherlands	58.5	60.8	63.1	65.5	*71.2*	*74.6*
Austria	63.8	69.2	72.0	72.5	*73.4*	*73.8*
Portugal	71.7	83.7	94.0	108.3	*123.6*	*123.0*
Slovenia	22.0	35.0	38.6	46.9	*54.1*	*61.0*
Slovakia	27.9	35.6	41.0	43.3	*52.1*	*54.6*
Finland	33.9	43.5	48.6	49.0	*53.0*	*56.2*
EMU-17	70.1	80.0	85.4	87.3	*90.6*	*95.5*
Bulgaria	13.7	14.6	16.2	16.3	*18.5*	*17.9*
Czech Republic	28.7	34.2	37.8	40.8	*45.8*	*48.3*
Denmark	33.4	40.7	42.7	46.4	*45.8*	*45.0*
Latvia	19.8	36.9	44.4	41.9	*40.7*	*43.2*
Lithuania	15.5	29.3	37.9	38.5	*40.7*	*40.1*
Hungary	73.0	79.8	81.8	81.4	*79.2*	*79.7*
Poland	47.1	50.9	54.8	56.2	*55.6*	*57.5*
Romania	13.4	23.6	30.5	34.7	*37.8*	*38.6*
Sweden	38.8	42.6	39.4	38.4	*38.2*	*40.7*
United Kingdom	52.3	67.8	79.4	85.5	*90.0*	*95.5*
EU-27	62.2	74.6	80.0	82.5	*85.3*	*89.8*

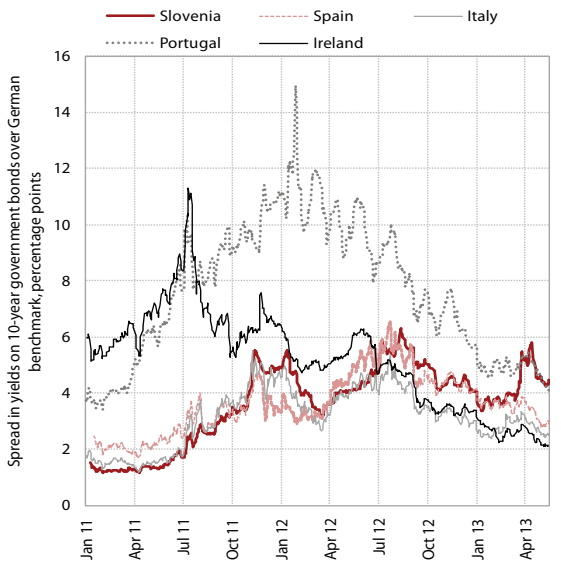
Source: Eurostat, European Commission Spring Economic Forecast 2013.
Note: * European Commission forecast.

Table 3: **General government debt in the euro area**

	2009	2010	2011	2012	2013
Gross debt (as % of GDP)	80.0	85.6	88.0	92.7	95.5
Change in gross debt (percentage points)	9.8	5.6	2.4	4.7	2.8
Factors contributing to change in gross debt (percentage points)					
Primary balance	*3.5*	*3.4*	*1.1*	*0.6*	*-0.2*
Interest	*2.9*	*2.8*	*3.0*	*3.1*	*3.1*
GDP growth	*3.2*	*-1.5*	*-1.2*	*0.5*	*0.4*
Inflation	*-0.7*	*-0.6*	*-1.1*	*-1.1*	*-1.4*
Adjustments	*0.9*	*1.6*	*0.5*	*1.5*	*0.9*

Source: European Commission, Spring Economic Forecast 2013.

Figure 3: **Spread in yields on 10-year government bonds over the German benchmark, percentage points**



Source: Bloomberg.

Yields on the government bonds of the most vulnerable euro area countries rebounded in the aftermath of the Cyprus crisis in March, and they remain relatively high. A variety of factors have affected the mood of financial investors and the yield curves of long-term euro area bonds since the outbreak of the crisis. In principle the yield curves are driven by long-term fiscal and macroeconomic indicators, but since 2011 in particular the mood of investors and the spreads of the most vulnerable countries have been influenced to an ever larger extent by political factors, one-off events and confidence indicators. In 2012 another key driver of spreads was speculation about a possible break-up of the euro area or the formation of a two-speed euro area. While the yields of vulnerable countries were high mid-year, the yield on German bonds dropped below 1% and remained very low for the Netherlands, Austria and France. The widening spreads between countries in the same currency area highlight the problem of insufficient coordination between the single monetary policy and the fiscal policies that remain under the control of the individual countries, which is reflected in substantial differences in the mood and decisions of financial investors. The yields in vulnerable countries and the spreads over German benchmark bonds fell substantially in October 2012, largely on account of the decision by the ECB to purchase on the secondary market the bonds of countries that requested ESM financial assistance, albeit under strict terms. The financial markets were also appeased by decisions adopted at EU level in September last year regarding the convergence of the economic and monetary union and common bank supervision as a precondition for an effective banking union.[6] The situation deteriorated in March of this year, when Cyprus requested financial assistance, as the initial lack of clarity as to the substance of the aid programme raised uncertainty about the potential bailouts of other vulnerable countries. Increased demand for safe investments meanwhile drove down the yields of AAA-rated government bonds.

Last year the ECB also provided liquidity to banks with limited access to funding, contributing to an easing of tensions on the financial markets. The ECB took a more proactive role at the end of 2011 by tackling tensions on euro area financial markets with non-standard measures. In 2012 it provided funding to euro area banks through long-term refinancing operations[7] and adopted measures to expand eligible collateral, while the Eurosystem injected liquidity into banks through ordinary tenders. These measures made it possible for banks with limited access to funding, especially those in the most vulnerable countries, to secure liquidity, thereby contributing to a reduction of tension on the financial markets.

In the past two years crucial steps were made towards the strengthening of economic governance and fiscal policy coordination in the EU. Following

[6] The principal pillars of the banking union are common supervision, a bank bailout fund, and a deposit guarantee scheme. The supervisory role will be assumed by the ECB, which is designed to restore investor confidence. The bank bailout fund will provide a facility for maintaining banking system stability in the event of a bank bankruptcy, in particular when that would have a negative impact on the stability of the entire euro area. The purpose of the guarantee scheme for deposits of up to EUR 100,000 is to maintain depositor confidence and prevent bank runs when uncertainty spreads. The creation of a banking union will mitigate the negative reaction of the financial markets in the event of bank bailouts (at present bank bailouts by sovereigns are associated with a severe deterioration in the public

[7] Three operations were completed: the first (21 December 2011) provided EUR 489.2 bn to banks, the second (29 February 2012) EUR 529.5 bn.

the implementation of six pieces of legislation[8] binding on the entire EU, and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the fiscal compact),[9] which is binding on euro area countries, two additional regulations (the two-pack)[10] were adopted in March 2013 and set out in detail the implementation of the fiscal provisions of existing regulations. The measures *inter alia* enhanced the substantive supervision of national budgets. Draft budgets in all euro area countries thus have to be prepared no later than by 15 October and are then reviewed by the European Commission, which issues opinions by 30 November. If it finds major deviations from the plans presented in the Stability Programme, it requests corrections from the country in question. Failure to rectify the deviations or explain them in substantiated terms could, should this be deemed to pose a serious risk to euro area financial stability, significantly affect the European Commission's opinion of the country's compliance with commitments made within the framework of the excessive deficit procedure. According to the regulations, draft budgets must be based on independent macroeconomic forecasts, and surveillance of compliance with national fiscal rules must be carried out by an independent institution.

[8] It comprises five regulations and one directive and entered into force in December 2012. In substantive terms it amends the Stability and Growth Pact, introducing stricter requirements on the budgetary frameworks of EU countries and enhancing oversight of macroeconomic imbalances (see EI 2012, chapter 1).
[9] The treaty introduces a balanced budget rule and took effect on 1 January 2013. The signatories must transpose the balanced budget rule into their national legal systems one year after the entry into force of the treaty, either by amending their constitutions or adopting a legislative instrument with equal force (for details of the fiscal compact, see EI 2012, chapter 1).
[10] A regulation on enhanced surveillance of euro area member states that are experiencing or threatened with serious financial difficulties, or that request financial assistance (6726/13) and a regulation on enhanced monitoring and assessment of draft budgetary plans of euro area Member States, with closer monitoring for those in an excessive deficit procedure (6727/13).

2. Public finances in Slovenia in 2012

Having remained around 6% of GDP for three years, Slovenia's general government deficit narrowed significantly last year as a result of fiscal consolidation measures, to its lowest level since the outbreak of the crisis in 2008 (4% of GDP). The deficit surged in 2009 and remained roughly at that level thereafter, largely as a result, in particular in 2011, of one-off factors. Excluding one-off factors, the deficit narrowed slightly in 2010 and 2011, but in 2012 the pace of consolidation picked up substantially,[11] primarily as a result of expenditure-side measures. The deficit narrowed by 2.4 percentage points compared with 2011, and by 1.5 percentage points excluding one-off expenditure increases in both years.[12] The deficit was generated mostly at the central government level (3.8% of GDP). Local government recorded a small surplus (0.1% of GDP), while the deficit of the social security funds widened significantly relative to the previous year (0.3% of GDP).[13] For the first time since the outbreak of the crisis, the adopted measures led to a substantial decline in the cyclically adjusted deficit, from -5.7% of GDP in 2011 to -2.8% of GDP in 2012 (the structural deficit[14] narrowed from -4.4% of GDP to -2.4% of GDP; see Chapter 2.1).

Last year's fiscal consolidation drive was largely underpinned by expenditure cuts; in contrast to previous years, a significant fiscal effort was achieved as expenditure declined in nominal terms for the first time, and was also down as a share of GDP. General government expenditure contracted by 5.4% or about EUR 1.0 bn last year, declining by

[11] In 2010 and 2011 the deficit reduction (excluding one-off factors) was based principally on increasing revenue, and partially on scaling down the flexible part of expenditure and emergency measures involving wages in the general government sector and social transfers.
[12] In 2011 due to the recapitalisation of a bank and several government-owned companies and the assumption of debt from several companies (1.3% of GDP), and in 2012 due to the coverage of losses at government-owned companies with recapitalisation, called government guarantees, recognition of the liabilities of government-owned companies and super dividends (0.4% of GDP). The 2012 figures do not include the capital increase at NLB via the issue of contingent convertible (CoCo) bonds in the amount of EUR 320 million (issued in June 2012), which were converted into equity this year on account of the bank's loss in 2012.
[13] The deficit of the social security funds is primarily the result of a deficit at the Health Insurance Institute; this category also includes the Pension and Disability Insurance Institute and Kapitalska družba (KAD). The provisional decline in the deficit in 2011 was also affected by a EUR 90 million transfer from KAD to the Pension Fund.
[14] The structural deficit is the cyclically adjusted deficit stripped of the impact of specific one-off transactions.

Box 1: **Estimates of the impact of fiscal consolidation measures on economic activity using a DSGE model**

Assessments of fiscal consolidation measures using a dynamic stochastic general equilibrium (DSGE) model show consolidation measures have a direct impact on economic activity, but suggest that non-consolidation has the biggest adverse impact. A rough estimate of the direct impact is possible for fiscal consolidation based on a model simulation using a broad dynamic stochastic general equilibrium (DSGE) model, which explains the specifics of the Slovenian economy relatively well. The calculations show that an absence of consolidation has the biggest adverse impact on economic activity. In such circumstances the general government deficit would not be reduced or would even increase, which would further aggravate or indeed completely shut off the already limited access to funding on international financial markets, which in turn would very soon demand bigger and harsher cuts, and affect private sector financing. The model estimate is based on a comparison of the effects of permanent consolidation measures against the effects of a permanent increase in borrowing costs by 100 basis points (close to the limit of sustainability in the current circumstances) that would occur in the absence of consolidation measures. The comparison shows that the costs of non-consolidation are higher than the costs of any of the selected deficit cutting measures, as the negative impact of increased cost of capital at GDP level is highest and permanent, and affects GDP growth (see also EI 2012, Chapter 8).

Simulations of deficit-reduction measures show that their direct impact on the weakening of economic activity is greatest in the first three quarters after implementation. Simulation using data for 2011 shows that reducing different categories of expenditure (intermediate government consumption, social transfers and investments) by 1.8% of GDP had a direct negative impact on economic growth around the 1 percentage point range (depending on the assumption of the proportion of households with limited liquidity), with the impact strongest in the first three quarters after implementation. The decline in general government expenditure in 2012 reduced domestic demand, which directly affected economic activity. It is difficult to make a precise estimate of the impact of consolidation on economic growth, as the economy is subject to other domestic and international shocks, with all the impacts interacting and often feeding back into one another. The multi-year contraction in lending activity, a result of banking system woes (see the Impact of the financial crisis on the credit market in Slovenia, Economic Issues 2013), is making it exceedingly difficult to finance investments and working capital, weaker foreign demand is slowing export growth, and fiscal stimulus is not possible, as it would require additional borrowing that is not feasible given the financial markets' deteriorating mood as a result of Slovenia's non-compliance with its commitments to reduce the deficit. An additional factor that has put downward pressure on demand is increased consumer uncertainty, which is partly a result of the expenditure-side measures but also a consequence of the general deterioration in the labour market in recent years (see Challenges of the labour market, Economic Issues 2013). In assessing the direct impact of the measures in 2012, it is necessary to emphasise that the measures largely took effect at the beginning of May and affected last year's GDP growth proportionately, but also continued to exert a strong impact in early 2013.

Table 4: **General government revenue, expenditure and deficit , as % of GDP**

	2006	2007	2008	2009	2010	2011	2012
Total general government revenue	43.2	42.4	42.4	43.1	44.5	44.4	45.0
Total general government expenditure	44.6	42.4	44.3	49.3	50.4	50.8	49.0
General government deficit	**-1.4**	**0.0**	**-1.9**	**-6.2**	**-5.9**	**-6.4**	**-4.0**
General government deficit excluding one-off factors	*-1.4*	*0.0*	*-1.9*	*-6.2*	*-5.7*	*-5.1*	*-3.6*

Sources: SURS, Main aggregates of the general government sector, April 2012; calculations by IMAD.

1.8 percentage points to 49% of GDP (or by 3.7% or EUR 0.6 bn excluding one-off transactions in 2011 and 2012, a decline of 0.9 GDP percentage points).[15] Last year saw a continuation of cuts in expenditure that do not require legislative changes (investments, subsidies, material costs). However, expenditure cuts stemming from the implementation of three laws (Exercise of Rights to Public Funds Act,[16] Additional 2012 Intervention Measures Act[17] and Fiscal Balance Act [ZUJF][18]) also made a significant contribution to consolidation. All categories of expenditure declined, other than interest payments, which rose by EUR 54 m. Investments declined the most (by EUR 257 m), in what was the third consecutive year of contraction; in the last two years alone they have declined by almost

[15] See footnote 1.
[16] Official Gazette, No. 62/2010.
[17] Official Gazette, No. 110/2011.
[18] The Fiscal Balance Act, which amends 39 separate laws, was adopted by the National Assembly on May 12 2012.

Table 5: **Growth in total general government expenditure and contributions to growth made by individual categories, 2006–2012, percentage points**

	2006	2007	2008	2009	2010	2011	2012
Growth in total general government expenditure, %	6.7	6.1	12.5	6.3	2.4	2.2	-5.4
Contribution of intermediate consumption, percentage points	1.2	0.0	2.1	0.3	0.7	0.5	-0.4
Contribution of compensation of employees, percentage points	1.4	1.2	3.2	1.7	0.6	0.6	-0.8
Contribution of social benefits in cash, percentage points	2.2	1.8	3.9	2.7	1.6	1.4	-0.9
Contribution of gross capital formation and capital transfers, percentage points*	1.7	2.6	2.2	0.3	-0.6	-0.1	-3.4
Contribution of subsidies, percentage points	0.4	0.4	0.2	0.9	0.4	-1.8	-0.1
Contribution made by interest, percentage points	-0.1	0.0	-0.1	0.4	0.6	0.6	0.3
Contribution of other expenditure, percentage points	0.0	0.0	1.0	-0.1	-0.8	1.0	-0.1

Source: SURS, Main aggregates of the general government sector, April 2013; calculations by IMAD. Note: * Capital transfers surged in 2011 as a result of the recapitalisation of government-owned companies and the banking sector (EUR 270.4 m) and declined significantly in 2012. Excluding recapitalisation, total expenditure growth was 0.2% in 2011 and -3.7% in 2012 (contributions made by Gross capital formation and capital transfers: -2.7 percentage points in 2011 and -0.6 percentage points in 2012).

EUR 550 m. The decline in social benefits and benefits in cash and in kind (EUR 171 m) was largely the result of changes in eligibility criteria, as the conditions for obtaining social rights were tightened. The reduction in compensation of employees in the general government sector (by EUR 151 m) was driven by cuts to wages and other labour costs, and by a restrictive hiring policy. Intermediate government consumption declined (by EUR 67 m) as expenditure on goods and services was curbed, and subsidies also declined marginally (by EUR 13 m). Capital transfers were also down considerably last year (by EUR 359 m), having surged in 2011 as a result of the recapitalisation of government-owned companies and the banking sector.

Last year was the first time since 2009 that revenue also declined in nominal terms, though it rose marginally as a ratio to GDP. General government revenue declined by EUR 105 m (-0.7%). Despite the nominal decline, it rose as a ratio to GDP, by 0.6 percentage points to 45%, due to the contraction in economic activity. The revenue dynamics were driven largely by the weakening of the economy and partly by tax changes. Despite a significant increase in certain tax burdens,[19] their positive impact was largely offset by declining corporate income tax revenue.[20] Moreover, the relatively high price elasticity of demand led to a decline in sales of liquid fuels in quantitative terms and a decline in excise revenue towards the end of the year. Total revenue from taxes and social security contributions fell (by 0.9% and 0.8% respectively), whereas non-tax revenue rose marginally. The decline in tax revenue was chiefly a result of a decline in revenue from corporate income tax (by EUR 165 m or 27.1%). Even as labour income fell (by 0.4%), income tax revenue increased by 0.6% while social security contributions declined by 0.8%. Taxes on production and imports were also up (by 1.3%), owing primarily to higher excise duty revenues on the back of increased excise duties on all excisable products; VAT revenue declined by EUR 108 m or 3.6% as consumption was scaled back. Non-tax revenue, including transfer revenue (funds from the EU budget) rose by EUR 14 m, with EU funds reaching their highest level to date (EUR 842 m).

Table 6: **Growth in total general government revenue and contributions to growth made by individual categories, 2006–2012, percentage points**

	2006	2007	2008	2009	2010	2011	2012
Growth in total general government revenue, %	6.6	9.3	7.8	-3.0	3.4	1.4	-0.7
Contribution of taxes on production and imports, percentage points	1.5	2.8	1.4	-1.4	0.6	0.0	0.4
Contribution of current taxes on income, property, etc., percentage points	2.6	2.5	1.0	-2.5	-0.1	-0.2	-0.9
Contribution of social security contributions, percentage points	2.1	2.9	3.5	0.4	0.7	0.2	-0.3
Contribution of other non-tax and transfer revenue, percentage points	0.4	1.1	1.8	0.4	2.2	1.4	0.1

Source: SURS, Main aggregates of the general government sector, April 2013; calculations by IMAD.

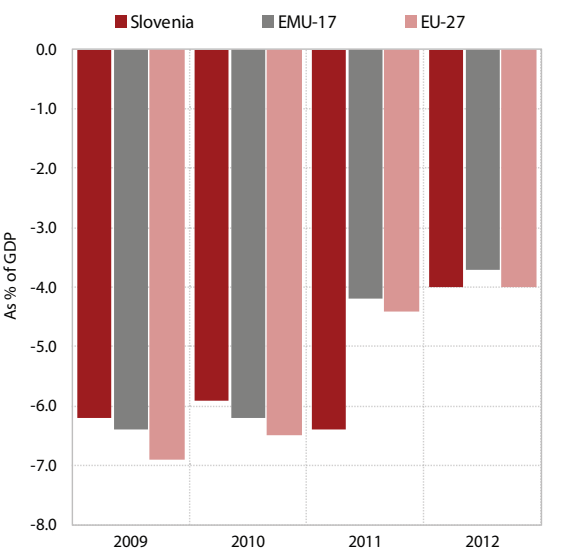
[19] Higher excise duties on tobacco and beer, adjustment of excise duties on motor fuels, additional tax on motor vehicles with engines of 2,500 cc or more, a crisis tax on real estate of higher value, a tax on gains from changes in land use, an environmental tax on CO2 emissions, higher annual duties for vehicles used in road transport.

[20] Against the backdrop of a severe deterioration in the macroeconomic environment, this was also a result of the cut in the tax rate to 18% from 20% and higher tax allowances for R&D and investments.

In qualitative terms, we estimate that steps towards a more sustainable restructuring of expenditure were achieved in 2012. Measures underpinned by systemic changes constituted a departure from the previously prevalent approach of temporary interventions in the flexible part of the budget. In contrast to previous years, fiscal consolidation measures to a greater extent involved structural changes backed by legislative changes, which will have a more permanent impact (e.g. changes in eligibility criteria for social benefits, lower unemployment benefits, lower percentage value of health services covered by compulsory insurance). However, some of the measures in the area of social transfers were temporary (e.g. freezing of the indexation of social transfers, tying eligibility for annual allowances for pensioners to the amount of the pension). Wages in the general government sector were cut on the basis of an agreement between the social partners, which, combined with the restrictions on hiring and contract-based work, reduced employee compensation in relative terms. Despite a shift towards more permanent changes, some of last year's measures were still stop-and-go policies, which if discontinued could raise expenditure again. Moreover, over half of the deficit reduction was still achieved by cutting the flexible portion of expenditure (investments, subsidies, expenditure on goods and services; these declined by 7.8% overall relative to 2011), which has not only narrowed the manoeuvring room for further cuts in the coming years, and is unsustainable in the long run, but also has a bigger negative impact on economic activity (see Box 1 and EI 2012, Chapter 8). Some of the revenue-side measures increased revenue from indirect taxes (excise duties and environmental taxes), whereas other measures simultaneously resulted in short-term revenue falls (the cut in the corporate income tax rate is thought to act as a stimulus to economic growth in the medium term, but it will not be possible to gauge the effectiveness of the measure for several years). The best way to roughly estimate the impact of the consolidation measures on households' income position is to evaluate the impact of the cuts in social transfers. One of the aims of the changes that reduced expenditure on social transfers was to more precisely target aid at the poorest, which should result in changes in the socio-economic status of a segment of the population. According to preliminary simulations,[21] disposable income should increase for those in the lowest income brackets and decline for those in higher income brackets, but a certain proportion of those in lower income brackets should also see a deterioration. An assessment of the impact of the new legislation, prepared on the basis of data on the first year of implementation,[22] shows a similar result (see Development Report 2013, Chapter 4). Combined with wage and hiring measures in the general government sector, cuts in expenditure on transfers to individuals and households reduced disposable income on aggregate, which was one of the key factors in the decline in private consumption.

Fiscal consolidation is only one of the factors driving the yields on government bonds. Based on the responses, it is assessed that consolidation had a positive impact on financial investors' mood, which would have deteriorated had there been no consolidation; it is nevertheless impossible to gauge the direct impact of the adopted deficit-reduction measures on borrowing terms. The impact of the passage of a pension reform was also positive. The reform did not affect last year's expenditure, but will help improve fiscal sustainability over the medium term (see Chapter 5). In general the yield curve in 2012 was strongly affected by other domestic factors associated with weaknesses in the banking sector, indications that Slovenia might have to request a bailout, worsening prospects for economic growth and political instability, and external factors that affected the yield curves of all vulnerable euro area countries (see Chapter 4).

Figure 4: **General government deficit in Slovenia and the EU, as % of GDP**



Source: Eurostat.

[21] Institute of Economic Research, Microsimulation Model.
[22] Social Protection Institute, Ocena učinkov nove socialne zakonodaje (Assessment of the impact of new social legislation), 2013.

Slovenia recorded one of the most pronounced reductions in the general government deficit in the EU in 2012, but its reduction relative to 2009 was still below the average in the EU and the euro area. Slovenia was one of the few EU countries whose fiscal position deteriorated in 2010 and 2011, but last year's deficit reduction was among the largest in the EU (second only to Ireland and Romania). A comparison with 2009, when public finances deteriorated sharply in all EU countries and Slovenia's deficit was only marginally below the euro area average, shows that Slovenia's consolidation effort throughout the entire period (2.2 percentage points) was below the EU and euro area average (2.9 percentage points and 2.7 percentage points respectively). This is particularly problematic given that Slovenia faces declining revenue against the backdrop of one of the deepest economic downturns in the EU, and it is also in the group of EU countries facing the greatest pressure on public finances due to an ageing population (see Chapter 4).

2.1. Cyclically adjusted and structural general government balance

The estimate of the structural balance indicates the stance and appropriateness of fiscal policy, and it is taking on a central role in the mechanism for monitoring fiscal policies in the euro area. Analysis of the cyclically adjusted balance[23] provides an additional insight into the impact of past fiscal policy measures, which can contribute to ex post estimates of fiscal policy stance and the determination of the causes of any imbalances in the past. The structural deficit had previously been defined as a medium-term fiscal objective in the Stability and Growth Pact. But the recent adoption of legislation and agreements on closer coordination of fiscal policies in the euro area (see Chapter 1), which amended the 2005 Stability and Growth Pact, strengthened its role as a benchmark in governance and surveillance of fiscal policy measures. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the fiscal compact) sets the structural balance as the reference point for a balanced budgetary position (or surplus) of the general government sector of the signatory countries, stipulating that the structural deficit may not exceed 0.5% of GDP over the medium term (the time frame of convergence towards the objective is determined by the European Commission taking into account the sustainability risks of individual countries; in Slovenia the structural deficit will be below 0.5% of GDP in 2017 according to the projections in the 2013 update to the Stability Programme [see Chapter 7]).

Utmost caution is required in assessing the structural balance considering the volatility of the estimates. The structural deficit is a substantively better indicator of the fiscal position than the actual general government balance, which can be strongly affected by cyclical and one-off factors. However, the role of the structural balance as a principal indicator of the fiscal policy stance and consolidation efforts can be problematic, in particular with regard to influencing decisions for the current and subsequent years and in conjunction with the balanced-budget provisions of the fiscal compact. The latter is particularly relevant, as breaching the provision, which the signatory countries must transpose into their national legislation with binding force and permanence, preferably constitutional,[24] may ultimately trigger sanctions. Use of the structural deficit is problematic in that the estimate thereof, coupled with changes associated with fiscal policy measures, is strongly affected by potential growth and output gap estimates, which are inherently volatile (Table 7). This is a consequence of methodological changes[25] and revised estimates of past economic growth as well as changes in forecasts precipitated by altered conditions and prospects in the domestic and international environment. Assessment of the structural balance is also affected by ex post revisions of estimates of the general government deficit. All this can radically change the estimate of the fiscal position, not only for the current and coming years but also ex post. This can lead to a situation where, for example, the structural deficit in the previous year is estimated as excessive relative to the balanced-budget provision, but subsequent calculations revise the estimate and show that the provision has not been breached (or vice-versa). Similarly, fiscal policy may be estimated ex post as counter-cyclical, while a subsequent calculation for the same year shows it was actually cyclical. Analysis of the cyclically adjusted balance and structural balance

[23] The cyclically adjusted general government balance indicates the fiscal result that would be achieved merely with the effects of fiscal policy, i.e. without the effect of cyclical factors. The structural deficit is a cyclically adjusted balance of public finances which does not take into account one-off transactions (in line with the ESA 95).

[24] Article 3.2 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (OJ EU C113/1, 18 April 2012; Official Gazette RS, No. 35/2012, 14 May 2012).

[25] This year the output gap is calculated based on a revised methodology in the production function. Instead of the Hodrick-Prescott filter (see Economic Issues 2010), a bivariate Kalman filter is being used to smooth out total factor productivity. For a detailed description of the methodology, see F. D'Auria, Cécile Denis, K. Havik, K. Mc Morrow, C. Planas, R. Raciborski, W. Röger and A. Rossi: The production function methodology for calculating potential growth rates and output gaps, Economic Papers 420, July 2010, DG ECFIN.

Table 7: **Actual, cyclical and cyclically adjusted general government balance, as % of GDP**

	Actual balance 1	Cyclical balance 2	Cyclically adjusted balance 3=(1-2)	Change in cyclically adjusted balance	Structural balance*	Change in structural balance
2000	-3.7	0.3	-4.0	-0.7	-4.0	-0.7
2001	-4.0	0.0	-4.0	0.1	-4.0	0.1
2002	-2.4	0.1	-2.6	1.4	-2.6	1.4
2003	-2.7	-0.1	-2.5	0.0	-2.5	0.0
2004	-2.3	0.1	-2.3	0.2	-2.3	0.2
2005	-1.5	0.4	-1.8	0.5	-1.8	0.5
2006	-1.4	1.3	-2.7	-0.8	-2.7	-0.8
2007	0.0	2.7	-2.8	-0.1	-2.8	-0.1
2008	-1.9	2.7	-4.5	-1.8	-4.5	-1.8
2009	-6.2	-1.6	-4.6	-0.1	-4.6	-0.1
2010	-5.9	-1.2	-4.7	-0.1	-4.5	0.2
2011	-6.4	-0.7	-5.7	-1.0	-4.4	0.1
2012	-4.0	-1.2	-2.8	2.9	-2.4	2.0
2013	-7.9	-1.5	-6.4	-3.6	-2.7	-0.3

Source: SI-Stat data portal – Economy – National accounts - Main aggregates of the general government sector (SURS), 2013 for actual balance; cyclical components calculated by IMAD. Note: 1 Cyclically adjusted balance not including one-off transactions. 2 Positive change represents an improvement in the balance. The figures do not necessarily sum fully due to rounding.

Table 8: **Estimate of structural components of the general government balance in 2013 and 2012**

	2013 estimates						2012 estimates					
	Actual balance (% GDP)	Cyclical balance	Cyclically adjusted balance	Structural balance	Output gap	Potential GDP growth	Actual balance (% GDP)	Cyclical balance	Cyclically adjusted balance	Structural balance	Output gap	Potential GDP growth
2000	-3.7	0.3	-4.0	-4.0	*-0.7*	*4.1*	-3.7	0.4	-4.2	-4.2	*1.0*	*4.0*
2001	-4.0	0.0	-4.0	-4.0	*0.0*	*3.6*	-4.0	0.2	-4.2	-4.2	*0.5*	*3.4*
2002	-2.4	0.1	-2.6	-2.6	*0.3*	*3.5*	-2.4	0.6	-3.0	-3.0	*1.3*	*3.1*
2003	-2.7	-0.1	-2.5	-2.5	*-0.3*	*3.5*	-2.7	0.4	-3.1	-3.1	*0.9*	*3.3*
2004	-2.3	0.1	-2.3	-2.3	*0.1*	*3.9*	-2.3	0.7	-3.0	-3.0	*1.6*	*3.7*
2005	-1.5	0.4	-1.8	-1.8	*0.8*	*3.3*	-1.5	1.0	-2.5	-2.5	*2.2*	*3.4*
2006	-1.4	1.3	-2.7	-2.7	*3.0*	*3.5*	-1.4	1.9	-3.2	-3.2	*4.3*	*3.8*
2007	0.0	2.7	-2.8	-2.8	*6.2*	*3.7*	0.0	3.1	-3.1	-3.1	*7.0*	*4.1*
2008	-1.9	2.7	-4.5	-4.5	*6.0*	*3.5*	-1.9	3.2	-5.1	-5.1	*7.3*	*3.3*
2009	-6.2	-1.6	-4.6	-4.6	*-3.6*	*1.4*	-6.1	-1.1	-4.9	-4.9	*-2.6*	*1.4*
2010	-5.9	-1.2	-4.7	-4.5	*-2.7*	*0.3*	-6.0	-1.0	-5.0	-5.0	*-2.2*	*1.0*
2011	-6.4	-0.7	-5.7	-4.4	*-1.5*	*-0.6*	-5.1	-1.2	-5.2	-3.9	*-2.8*	*0.4*
2012	-4.0	-1.2	-2.8	-2.4	*-2.8*	*-1.0*	-3.5	-1.7	-1.8	-1.8	*-3.9*	*0.3*
2013	-7.9	-1.5	-6.4	-2.7	*-3.5*	*-1.1*	-2.5	-1.4	-1.1	-1.1	*-3.3*	*0.5*

Sources: SURS, Economic Issues 2012 (IMAD), Stability Programme (2013 Update); calculations by IMAD.

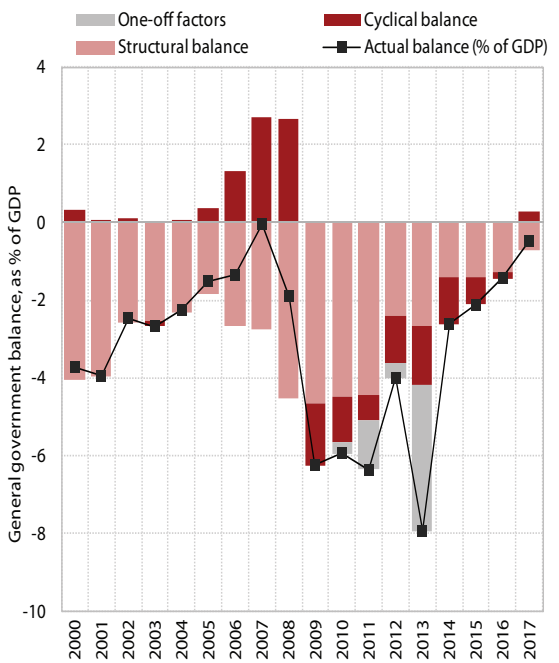
must therefore be undertaken with utmost caution being exercised in interpreting the fiscal position as a basis for economic policy making.

For the first time since 2005, the cyclical component of the deficit diminished significantly last year. Last year's consolidation measures also led to a substantial narrowing in the cyclically adjusted deficit, to 2.7% of GDP from 5.7% in 2011 (the structural deficit[26] narrowed to 2.4% of GDP from 4.4%). In the last three years the structural deficit thus narrowed by 2.2 percentage points, or 0.73 percentage points annually on average. This is roughly in line with the European Commission's requirements in the framework of the excessive deficit procedure for an annual reduction of 0.75 percentage points, but practically the entire reduction was achieved in 2012.

[26] The structural deficit is a cyclically adjusted deficit stripped of the impact of specific one-off transactions..

The cyclically adjusted deficit for 2012 and 2013 is higher than last year's calculations showed. The difference between last year's and this year's estimates of the cyclically adjusted (and structural) balance are the result of three factors: (i) a severe weakening of the economy, (ii) the slower-than-planned pace of consolidation last year, and (iii) one-off events associated with last year's measures to secure the capital adequacy of the domestic banks. In the calculation for 2012 the weakening of the economy and the growth prospects resulted in a stronger decline in potential GDP and a narrower output gap, which reduced the cyclical component and increased the structural component. Last year's cyclically adjusted balance was also affected, albeit to a smaller extent, by the difference in the actual balance, which was largely a consequence of one-off factors and did not affect the structural balance. In the calculation for 2013, meanwhile, the differences between the estimates of the cyclically adjusted balance were entirely the result of the significantly higher actual balance (see Chapter 7). Over 70% of the difference is attributable to one-off factors (bank recapitalisation in the total amount of 3.7% of GDP, of which 0.9 percentage points was from 2012, which needs to be factored into the 2013 deficit according to ESA 95 methodology). Some revisions were made to the output gap estimates for the previous years, especially for the 2004-2007 period, as a result of certain methodological changes. As a result, the cyclically adjusted deficit for these years is slightly wider than previously estimated.

Figure 5: **General government balance, Slovenia**

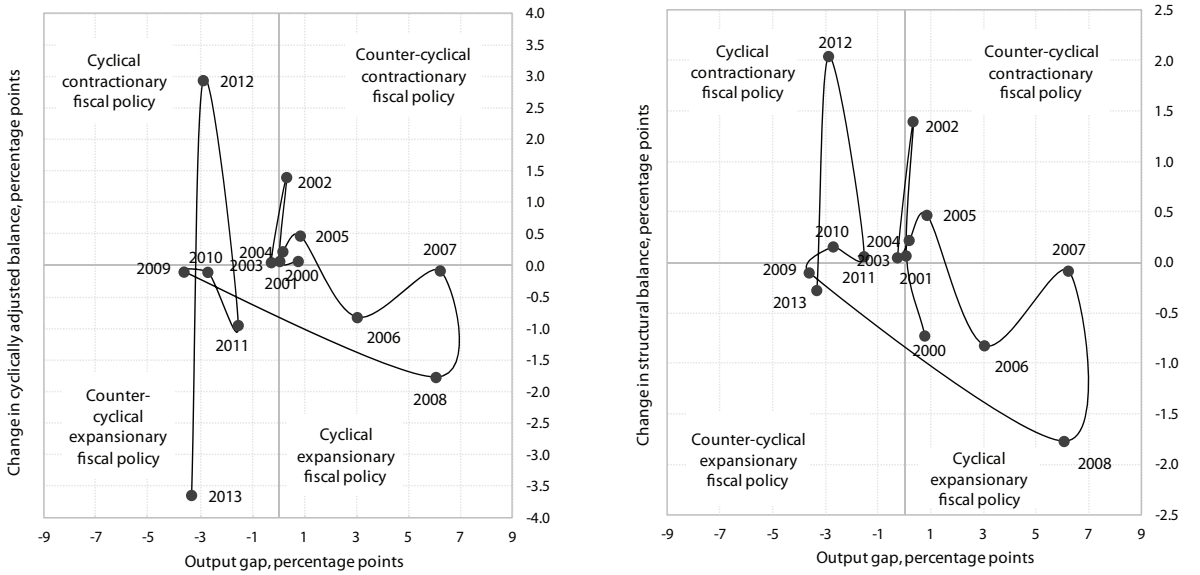


Sources: SURS; IMAD calculations.

Despite the volatility of the structural balance estimates, all recent estimates indicate that the structural position of Slovenia's public finances deteriorated substantially in 2008 and improved significantly in 2012. According to our estimates, the structural deficit widened by 1.8 percentage points to 4.6% of GDP in 2008 and remained at this level over the next two years. As a result of the weakened economic situation, the positive cyclical balance turned into a deficit (a deterioration of 4.3 percentage points) in 2009, which in turn led to a significant increase in the general government deficit that year. The cyclical and structural components of the balance remained at that level in 2010 and 2011 due to slow economic growth and negligible consolidation efforts, which were confined to capping wages and transfers with emergency measures (the cyclically adjusted deficit widened in 2011 as a result of the major impact of one-off factors). The structural deficit was thus the key element of the fiscal imbalance for three years, with the presented calculations suggesting that fiscal policy in the year before the crisis was a major contributor to the weakening of the public finances, while the financial and economic crisis further worsened the situation. It was not until 2012 that a notable positive change was achieved, as the structural deficit narrowed by over 2 percentage points as a result of fiscal consolidation efforts (see Chapter 2).

A comparison of the dynamics of the cyclically adjusted deficit and the output gap shows whether fiscal policy is cyclical or counter-cyclical. A change in the cyclically adjusted balance in consecutive years indicates the fiscal policy stance, i.e. the fiscal impulse. By comparing the change in the cyclically adjusted balance and the output gap, which indicates fluctuations in the economic cycle, it is possible to assess the fiscal policy stance (i.e. the fiscal position). A positive fiscal impulse, for example, means an increase in the cyclically adjusted deficit in the current year compared with the previous year. The varying distances of individual points from the axes indicate the intensity of fiscal policy. In Figure 6, there are four distinct quadrants of changes in the fiscal impulse and output gap that 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 becomes expansionary; when actual growth exceeds potential GDP growth, it responds in a contractionary manner. Fiscal policy is cyclical if the combination of the two parameters lies in the second or fourth quadrant. This means that when economic growth falls below its potential, fiscal policy becomes contractionary; when actual growth exceeds potential GDP growth, it responds

Figure 6: **Cyclical stance of fiscal policy taking into account the cyclically adjusted (left) and structural balances**



Source: SI-Stat data portal – Economy – National accounts - Main aggregates of the general government sector (SURS), 2011 for actual balance; Spring Forecast 2011 (IMAD); cyclical components calculated by IMAD.

in an expansionary manner. A cyclical stance means that fiscal policy does not allow for the functioning of automatic stabilisers, the result being that, for example, expenditure changes 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 reduce the deficit.

The calculations show that fiscal policy was fairly neutral in 2009-2011, turning explicitly contractionary and cyclical last year and then again becoming slightly counter-cyclical and expansionary this year (even excluding one-off bank recapitalisation expenditure). Much like in previous years, this year's calculations (with minor changes) indicate that a fiscal deterioration occurred in 2008, when fiscal policy was strongly cyclical and expansionary. In addition to certain factors that are inherently more cyclical than structural,[27] 2008 saw an increase in the structural component of the deficit as a result of measures taken in 2007 and 2008. These measures are estimated to primarily include increased expenditure on investment and social transfers,[28] and higher wages following the implementation of the new wage system in the public sector which coupled with increased hiring raised expenditure. By contrast, the tax changes in place reduced revenue: the general personal income tax allowance was increased, while the payroll tax was phased out and the corporate income tax rate was cut. In 2009, when the economy contracted sharply and the output gap was negative, fiscal policy was counter-cyclical as the structurally adjusted deficit remained high, but it is assessed as not being expansionary. Fiscal policy retained a similar stance in 2010 and 2011. In 2012, against the backdrop of a significant decline in the deficit, fiscal policy was strongly contractionary and acted counter-cyclically given the wider output gap. Despite reservations as to the calculations of changes in the structurally adjusted deficit, it is estimated that the fiscal policy stance in the past four years, in particular in 2012, was primarily a consequence of the fiscal restrictions linked to the commitments that Slovenia made as part of the excessive deficit procedure, and limited access to funding. In 2013 the commitment will not yet be implemented (see Chapter 7); based on the projections in the 2013 update to the Stability Programme, the stance of fiscal policy will shift slightly towards expansionary and counter-cyclical (even excluding the bank recapitalisation expenditure).

[27] The economy and, by extension, public finances, had already started to deteriorate in the final months of 2008 as the economic and financial crisis escalated, but this was not yet sufficiently reflected in the output gap. The calculated fiscal position in 2008 does not take into account the fact that the revenue shortfall was caused by a slowdown in economic activity, which per se already amounts to counter-cyclical action.

[28] 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 (subsidising of transport, food and rents, and new measures such as free meals for secondary school children and higher kindergarten subsidies), which is probably also related to the election cycle (elections in the autumn of 2008).

2.2. Simulations of the fiscal rule and the impact of altered circumstances on its calculation

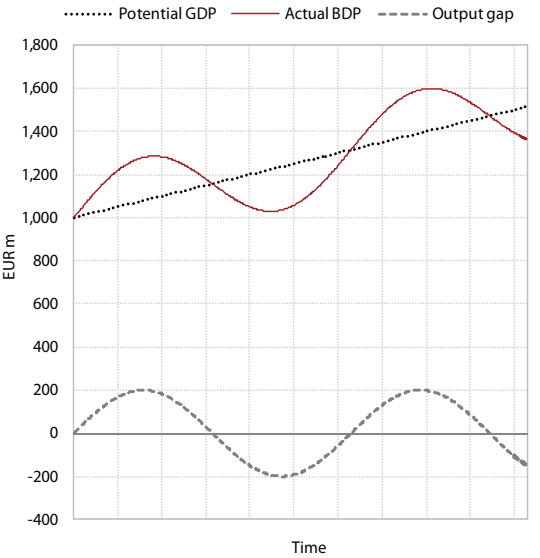
Amendments to Article 148 of the Constitution and the implementing act on the fiscal rule will implement Slovenia's balanced-budget commitment under the fiscal compact. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the fiscal compact) defines the balanced-budget rule via the structural balance. Slovenia ratified the treaty in May 2012 and amended the constitution by including the fiscal rule to implement the balanced budget provision (see Chapter 1). Below is an examination of the simulation of the fiscal rule as determined by the amended Article 148 of the Constitution of the Republic of Slovenia and last year's draft implementing act for the constitutional fiscal rule. A balanced budget of the general government sector (according to the ESA 95) is achieved by capping expenditure at the level of forecast revenue and multiplying it by the ratio of trend GDP to forecast GDP (the k coefficient).[29]

The way that the fiscal rule is defined, it is significantly affected by the assessment of the business cycle. Trend GDP is the GDP corresponding to long-term stable economic growth over the duration of the business cycle, and equals the output achieved at full employment of production factors and stable inflation; it can be equated with potential GDP (Figure 7). The difference between actual and potential GDP is the output gap. When actual GDP exceeds potential GDP, the output gap is positive; when it is below potential, the output gap is negative. Put differently, the output gap indicates the position in the business cycle and is incorporated in the fiscal rule via the k coefficient (k=1/(1 + {output gap}/100)).

The purpose of the fiscal rule is to have a contractionary impact on expenditure in good times and an expansionary impact in bad times. The fiscal rule limits expenditure by "correcting" the projected revenue for the impact of the business cycle (coefficient k). The rule thus attempts to limit expenditure irrespective of the business cycle. In "favourable" times (positive output gap) the correction is contractionary and allows for surpluses, in "unfavourable" times (negative output gap) the "correction" acts as a stimulus and allows for deficits (Figure 8).

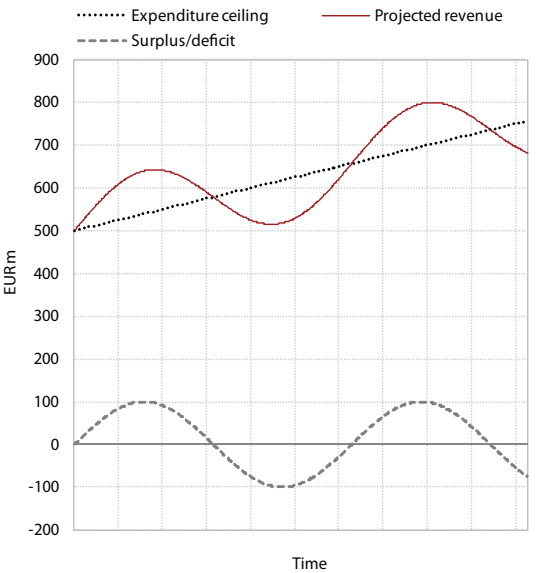
[29] The calculations using this coefficient take into account the requirements of the Stability and Growth Pact under the Council Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies no. 1455/97.

Figure 7: **Stylised business cycle: actual and potential GDP, and output gap**



Source: calculations by IMAD.

Figure 8: **Simulated action of the fiscal rule**



Source: calculations by IMAD.

The simulation of the fiscal rule is an estimate of the expenditure ceilings for the coming years using ESA 95 methodology. According to best practice promulgated by international institutions, such simulations use certain assumptions in the estimation methods (particularly important is the output gap, whose estimates change over time). Using slightly different assumptions or methods for the assessment of individual variables can therefore produce different results. To ensure the comparability of results, we used the same methodology as the European Commission. The rule was simulated at "general government" level,

Table 9: **Fiscal rule simulation, April 2012**

		2012	2013	2014	2015
GDP	EUR m	35,641	36,589	38,059	39,634
Output gap	as % of potential GDP	-3.9	-3.3	-2.0	-0.8
K coefficient		1.041	1.034	1.021	1.009
Revenue projection	EUR m	15,922	16,146	16,682	17,321
Expenditure ceiling	EUR m	16,573	16,692	17,028	17,469
Revenue projection	% of GDP	44.7	44.1	43.8	43.7
Expenditure ceiling	% of GDP	46.5	45.6	44.7	44.1
Surplus/deficit	**EUR m**	**-651**	**-546**	**-346**	-148
Surplus/deficit	**% of GDP**	**-1.8**	**-1.5**	**-0.9**	-0.4
MF expenditure projection	EUR m	17,188	17,070	17,260	17,479
Difference	EUR m	-615	-378	-232	-10
Difference	% of GDP	-1.7	-1.0	-0.6	0.0

Sources: SURS, MF, IMAD; calculations by IMAD..

Table 10: **Fiscal rule simulation, October 2012**

		2012	2013	2014	2015
GDP	EUR m	35,700	35,495	36,129	37,324
Output gap	as % of potential GDP	-2.8	-3.9	-3.1	-1.9
K coefficient		1.029	1.040	1.032	1.019
Revenue projection	EUR m	15,983	16,807	16,670	17,098
Expenditure ceiling	EUR m	16,441	17,485	17,207	17,426
Revenue projection	% of GDP	44.8	47.3	46.1	45.8
Expenditure ceiling	% of GDP	46.1	49.3	47.6	46.7
Surplus/deficit	**EUR m**	**-458**	**-678**	**-537**	-329
Surplus/deficit	**% of GDP**	**-1.3**	**-1.9**	**-1.5**	-0.9
MF expenditure projection	EUR m	17,482	17,923	17,682	17,567
Difference	EUR m	-1,040	-438	-475	-140
Difference	% of GDP	-2.9	-1.2	-1.3	-0.4

Sources: SURS, MF, IMAD; calculations by IMAD.

Table 11: **Fiscal rule simulation, May 2013**

		2012	2013	2014	2015	2016	2017
GDP	EUR m	35,466	35,252	35,735	36,810	38,110	39,457
Output gap	as % of potential GDP	-2.8	-3.5	-2.8	-1.6	-0.4	0.6
K coefficient		1.029	1.036	1.029	1.016	1.004	0.994
Revenue projection	EUR m	15,895	16,037	16,727	16,850	17,263	17,698
Expenditure ceiling	EUR m	16,351	16,612	17,204	17,120	17,327	17,590
Revenue projection	% of GDP	44.8	45.5	46.8	45.8	45.3	44.9
Expenditure ceiling	% of GDP	46.1	47.1	48.1	46.5	45.5	44.6
Surplus/deficit	**EUR m**	**-456**	**-575**	**-477**	**-270**	**-64**	**108**
Surplus/deficit	**% of GDP**	**-1.3**	**-1.6**	**-1.3**	**-0.7**	**-0.2**	**0.3**
MF expenditure projection	EUR m	17,313	18,835	17,661	17,630	17,809	17,881
Difference	EUR m	-962	-2.224	-456	-510	-482	-291
Difference	% of GDP	-2.7	-6.3	-1.3	-1.4	-1.3	-0.7

Sources: SURS, MF, IMAD; calculations by IMAD.
Note: expenditure includes one-off expenditure.

which according to ESA 95 methodology includes the national budget, municipal budgets, the publicly funded Pension and Disability Insurance Institute (PDII) and Health Insurance Institute (HII), direct and indirect users of the national and municipal budgets, and legal persons relying on public funding for over 50% of their revenue. The general government sector also includes Slovenska odškodninska družba, the portion of Kapitalska družba that covers liabilities to the PDII, and D.S.U., družba za svetovanje in upravljanje, d.o.o. As a result, the calculations include all legal entities whose conduct affects the size and dynamics of the general government debt and deficit, using the method that is also applied by the European Commission.

During the course of the simulations of the fiscal rule, significant changes occurred within the period of a year that were strongly affected by factors that are also critical to the calculation of the structural balance. The simulations presented below were made in April 2012, October 2012 and April 2013, always factoring in the latest available macroeconomic forecasts by IMAD and projections by the Ministry of Finance. Comparison thereof shows that the calculations are very volatile. The results of the simulations are also strongly affected by factors critical to the calculation of the structural deficit, which in turn affects the volatility of the estimate of the deficit ceiling. In addition to ex post revisions of estimates of macroeconomic and fiscal aggregates and methodological adjustments, changes in the forecasts of these aggregates have a decisive impact on the results. Forecasting changes are informed by a variety of factors, in particular altered circumstances in the domestic and international environment, and the impact of economic policy measures adopted in the interim period between two forecasts. A comparison of revised macroeconomic forecasts and revenue estimates also shows that there are divergences that cannot be explained solely by tax policy changes.[30] It is due to all these factors that the estimate of the deficit ceiling is not "unchangeable". Forecasting changes, as well as changes in data for previous periods, can change the estimates of the deficit ceiling. According to the simulations, the deficit ceiling in 2015 would be 0.4% of GDP based on IMAD's Spring Forecast from last year, 0.9% of GDP based on the Autumn Forecast and 0.7% of GDP based on the projections made this spring. In future, therefore, revised forecasts will very likely change the estimates of the deficit ceiling. Unchanged estimates of the deficit ceiling would be an exception rather than a rule when updated figures are used. Nevertheless, revised estimates are inherent to practically all methods that allow for the adjustment of the deficit/surplus to phases of the business cycle.

Simulations of the fiscal rule through 2017 (Table 11) based on this year's macroeconomic and fiscal projections suggest that its implementation will require additional consolidation efforts (assuming other circumstances remain unchanged).[31] Simulations of the fiscal rule were used to assess the deficit ceiling for individual years depending on the phase of the business cycle. In Tables 9-11 general government expenditure projections are based on the current system of revenue, meaning that the projections of the individual categories of taxes, social security contributions, non-tax revenue and other general government revenue take account of the current bases and rates without regulatory changes. Based on these assumptions, the simulations (bottom part of Table 9) show that total expenditure will exceed the fiscal rule ceiling by EUR 2.2 bn or 6.3% of GDP in 2013, EUR 0.5 bn or 1.3% to 1.4% of GDP in 2014–2016, and EUR 0.4 bn or 1% of GDP in 2017.

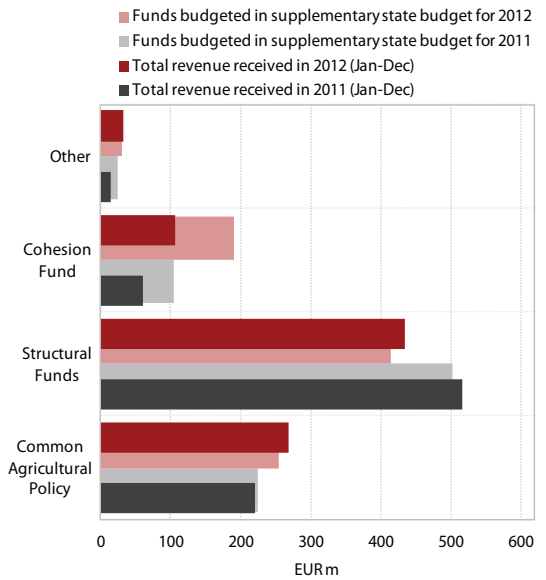
[30] The divergences in GDP forecasts and tax revenue was also highlighted by the Court of Audit in the audit report Effectiveness and Efficiency of Budgeting in the Republic of Slovenia for 2011 and 2012 (Court of Audit, 2012).

[31] Deviations from the fiscal rule are possible in exceptional circumstances. They are defined as an "unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact, provided that the temporary deviation of the Contracting Party concerned does not endanger fiscal sustainability in the medium-term" (Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union, Article 3.3.b). The implementing act will also determine the criteria for when circumstances may be considered extraordinary and the course of action when they occur.

3. Financial flows between Slovenia and the EU budget

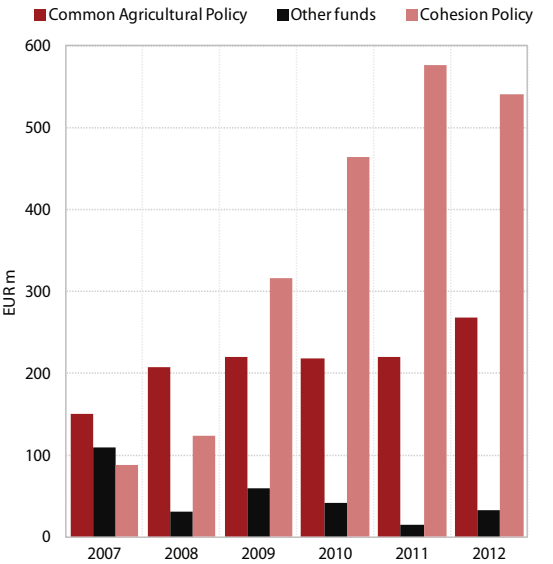
In 2012 the net position of the Slovenian budget against the EU budget was the highest since 2004. Ministry of Finance (MF) figures show that revenue from the EU budget into the Slovenian budget in 2012 (EUR 841.6 m) was the highest since 2004 (as in 2011, the realisation of the forecast revenue for the year was 95%[32]). Expenditure from the state budget into the EU budget amounted to EUR 390.3 m last year, resulting in a net position of the state budget against the EU budget of EUR 451.3 m, the highest figure since Slovenia joined the EU. Structural funds accounted for the majority of the funds received (EUR 434.8 m), two-thirds of which was from the European Fund for Regional Development (EUR 326.3 m) and a third from the European Social Fund (EUR 107.4 m). Realization of revenue from the Structural Funds and the Common Agricultural and Fisheries Policy stood at 105%, while the absorption of funds from the Cohesion Fund, which were earmarked entirely for environmental and transport infrastructure projects, reached only 56% of the forecast revenue.

Figure 9: **Forecast and absorbed funds from the EU budget, 2011 and 2012**



Source: Ministry of Finance; IMAD calculations.

Figure 10: **Breakdown of funds allocated from the EU budget to the state budget in the current financial period (2007 -2012)**



Source: Ministry of Finance, department for cooperation with EU budget.

Table 12: **Forecast and actual revenue and expenditure flows between the EU budget and the Slovenian budget, 2004-2012**

	Revenue			Expenditure			Net position
	Forecast	Actual	Realisation, %	Forecast	Actual	Realisation, %	
2004	335.3	183.8	54.8	187.9	170.0	90.2	13.8
2005	483.7	302.4	62.5	305.2	285.6	93.6	16.8
2006	449.6	348.4	77.5	315.0	287.9	91.4	60.5
2007	582.1	347.2	59.7	317.1	355.9	112.2	-8.7
2008	783.0	363.2	46.4	375.3	427.9	114.0	-64.7
2009	814.0	594.9	73.1	452.0	439.3	97.2	155.6
2010	1.037.8	723.2	69.7	412.8	396.8	96.1	326.4
2011	854.2	812.2	95.1	393.6	405.1	102.9	407.1
2012	888.6	841.6	94.7	403.3	390.3	96.7	451.3

Source: Ministry of Finance, department for cooperation with EU budget.

[32] Supplementary budget for 2012.

In the 2007-2013 financial period Cohesion Policy accounted for the bulk of Slovenia's eligible funds. In the 2007-2013 financial period grants of EUR 4.2 bn were approved for Slovenia under Cohesion Policy[33] funding and EUR 1.8 bn for the implementation of the Agricultural and Fisheries Policies, while the share of funding falling under other policies was much smaller. Slovenia began absorption of Cohesion Policy funds at a brisker pace in 2009 (in 2007 and 2008 it was still mostly absorbing funds from the previous financial perspectives), while the absorption of the Common Agricultural and Fisheries Policy funds has been fairly steady throughout the entire period.

In terms of the absorption of eligible Cohesion Policy funds, Slovenia is on the edge of the upper third of all EU countries and among the most successful new member states; nevertheless, certain measures were adopted towards the end of the current financial perspectives last year to improve absorption of these funds. A total of 98% of the grants under Cohesion Policy funding (EUR 4.1 bn) were earmarked for the implementation of the three leading cohesion policy Operational Programmes (OPs): OP RR,[35] OP ROPI[36] and OP RČV,[37] and EUR 104 m for European territorial cooperation. By the end of 2012 Slovenia had absorbed 43.7% of all eligible Cohesion Policy funds for the 2007-2013 period, whereby the funding it has received has been affected heavily by the deterioration in the economic situation since 2008, much as it has been in other EU countries. According to European Commission figures,[38] which include member states' biggest and most important Cohesion Policy projects, Slovenia ranked ninth (seventh in 2011) in terms of the absorption of eligible funds in 2007-2011 and eleventh (ninth in 2011) in terms of the absorption of eligible funds in the 2007-2013 period. Of the new member states, Slovenia was fifth in terms of the absorption of eligible funds 2007-2011 and fourth in the 2007-2013 period. Slovenia achieved its highest absorption of eligible funds for OP RR projects (60.8% of eligible funds in 2007-2013) and the lowest for OP ROPI projects (23.7%). The relatively low absorption of eligible Cohesion Policy funds could cost Slovenia a significant portion of grants in the current financial period (N+3/2 rule).[39] A portion of the eligible funds was therefore redirected last year to programmes where absorption was more feasible[40] and additional,

Table 13: **Absorption of eligible cohesion policy funds for the 2007–2012 period (as at 4 January 2013)**

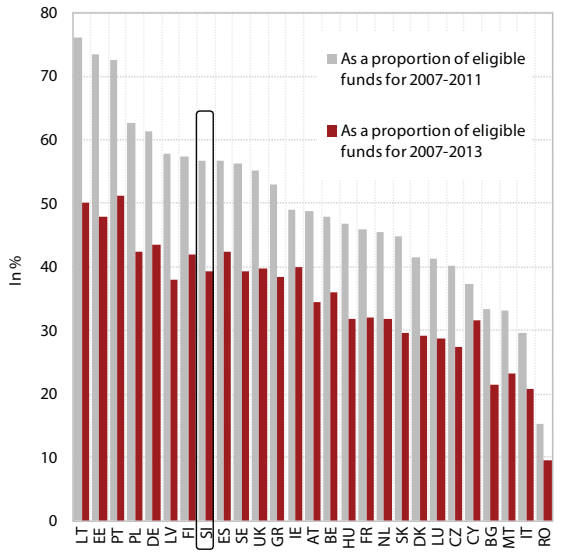
	In EUR million				% with regard to eligibility 2007-2011 [34]				% with regard to eligibility 2007-2013			
	OP ROPI	OP RR	OP RČV	Total all OP	OP ROPI	OP RR	OP RČV	Total all OP	OP ROPI	OP RR	OP RČV	Total all OP
Eligibility 2007 – 2013 (European funds)	**1,577.1**	**1,768.2**	**755.7**	**4,101.0**								
Eligibility 2007 2011	883.2	1,257.7	530.9	2,671.8								
Appropriations	1,188.9	1,534.2	696.2	3,419.3	134.6	122.0	131.1	128.0	75.4	86.8	92.1	83.4
Signed contracts	723.5	1,529.3	677.6	2,930.4	81.9	121.6	127.6	109.7	45.9	86.5	89.7	71.5
Disbursements	425.1	1,212.1	410.6	2,047.8	48.1	96.4	77.3	27.0	27.0	68.5	54.3	49.9
Refunds to state budget	373.0	1,074.6	345.8	1,793.4	42.2	85.4	65.1	67.1	23.7	60.8	45.8	43.7

Source: Ministry of Economic Development and Technology.

[33] In the 2007-2013 financial perspective Cohesion Policy funds are drawn from structural funds (European Regional Development Fund and European Social Fund) and the Cohesion Fund.
[34] The performance in the absorption of Cohesion Policy funds is estimated relative to total eligible funds for the current financial period (2007-2013) as well as against eligible funds for the 2007-2011 period, as the funds allocated in this period are absorbed until the end of 2013/14 (N+2/3 rule).
[35] Operational Programme for Strengthening Regional Development Potentials.
[36] Operational Programme for Environmental and Transport Infrastructure Development.
[37] Operational Programme for Human Resource Development.
[38] In addition to the payments registered in the state budget, it also includes payments to final beneficiaries in Slovenia based on centralised EC tenders that do not constitute budget revenue.
[39] Funds allocated in year N must be absorbed no later than within two or three years.
[40] EUR 58.5 m was reallocated from OP ROPI (transport infrastructure) to OP RR (competitiveness and development excellence).

i.e. excess, entitlements were allocated to individual OPs in order to maximise the absorption of eligible Cohesion Policy funds:[41] 16.56% to OP ROPI, 5% to OP RR and 5% to OP RČV on top of the existing eligible funds. Combined with accelerated certification of projects, these measures should make it possible to replace high-risk projects with feasible projects.

Figure 11: **Absorption of cohesion funds by EU countries as a proportion of eligible funds for 2007-2011 and 2007-2013 (as at 1 January 2011)**



Source: EC (European Commission – EU Budget)

4. General government debt

As in the previous years, last year's EUR 2.2 bn increase in the general government debt was the result of the financing of the deficit and the rolling over of debt. Interest payments also increased. The general government debt was estimated at EUR 19.2 bn or 54.1% of GDP at the end of 2012. The EUR 2.2 bn increase over 2011 was the result of deficit borrowing and the refinancing of liabilities in 2012 and 2013. The debt was up EUR 11 bn or 34.1 GDP percentage points on 2008, the most significant increases being recorded in 2009 (over EUR 4.3 bn or 13 GDP percentage points) and 2011 (EUR 3.2 bn or 8.3 GDP percentage points). Throughout the entire period debt growth was driven by deficit borrowing and borrowing to roll over debt. In 2009 and 2012 the debt-to-GDP ratio was also significantly affected by the nominal contraction in GDP (-4.5% and -2.0% respectively). Central government accounts for the bulk of total debt (52.5% of GDP, or 97% of total general government debt at the end of 2012) and is mostly long-term. Unconsolidated debt at local government level stood at 2% of GDP at the end of 2012, its growth having slowed down compared with the previous years,[42] while the debt of the social security funds was negligible at no more than 0.1% of GDP. Financing costs have risen as debt has swelled. Interest expenditure totalled EUR 748 m[43] last year, equivalent to 2.1% of GDP, up 0.2 percentage points on 2011 and up 0.5 percentage points on 2010. This indicates that over the last two years higher interest expenditure has already crowded out other expenditure.[44]

In 2012 long-term securities (EUR 2.2 bn) accounted for the majority of central government borrowing (76%), a trend that has continued into the first half of 2013. The borrowing structure in 2012 was affected in particular by the situation on the European debt market, and Slovenia's limited access to euro funding. The government thus issued bonds on the US market and borrowed from domestic banks. The majority of the financing of the budget in 2013 (EUR 1.7 bn) was thus obtained via the issue of a 10-year dollar-denominated bond on the US market (USD 2.25 bn), while the remainder was obtained via treasury bills and domestic loans.

[41] The actually exploited eligible funds could be lower than the available funds due to differences between preliminary estimates and subsequent contractual values. A review of deviations between estimated and contractual values from 2008 to 2010 showed that the contractual values are 20% below the estimates.

[42] Local government debt rose at a faster pace after 2009, when investment activity increased as a result of higher co-financing by European funds.

[43,44] According to ESA 95 methodology.

Table 14: **Consolidated general government debt by sub-sectors and interest payments, Slovenia, 2008–2012**

		2008	2009	2010	2011	2012
				EUR m		
1	**General government debt (total)**	**8,180**	**12,449**	**13,767**	**16,954**	**19,189**
1.1	Central government	8,091	12,110	13,204	16,347	18,606
1.2	Local government	354	523	626	685	702
1.3	Social security funds	3	2	52	52	52
1.4	Consolidated debt between sub-sectors	-268	-187	-146	-130	-172
	Interest payments (total)	**416**	**479**	**581**	**693**	**748**
				As % of GDP		
1	**General government debt (total)**	**22.0**	**35.0**	**38.6**	**46.9**	**54.1**
1.1	Central government	21.7	34.1	37.1	45.2	52.5
1.2	Local government	0.9	1.5	1.8	1.9	2.0
1.3	Social security funds	0.0	0.0	0.1	0.1	0.1
1.4	Consolidated debt between sub-sectors	22.0	35.0	38.6	46.9	54.1
	Interest payments (total)	**1.1**	**1.3**	**1.6**	**1.9**	**2.1**

Source: Main aggregates of the general government sector (SURS), 2013.
Note: Debt figures are consolidated (reduced by outstanding amounts between general government units).

Borrowing via treasury bills had started to increase in 2011, when access to the euro debt market was limited. The treasury bills were largely purchased by domestic banks, in particular those under government-ownership, as a means of obtaining securities eligible as collateral for borrowing from the ECB (see the section The Impact of the Financial crisis on the Credit Market in Slovenia). Treasury bills issues amounted to EUR 0.7 bn, while loans totalled EUR 0.5 bn. Borrowing via treasury bills continued in 2013 (a total of EUR 1.5 bn by May, the bulk again purchased by domestic banks), and in May the government issued 5-year and 10-year dollar-denominated bonds (USD 3.5 bn in total).

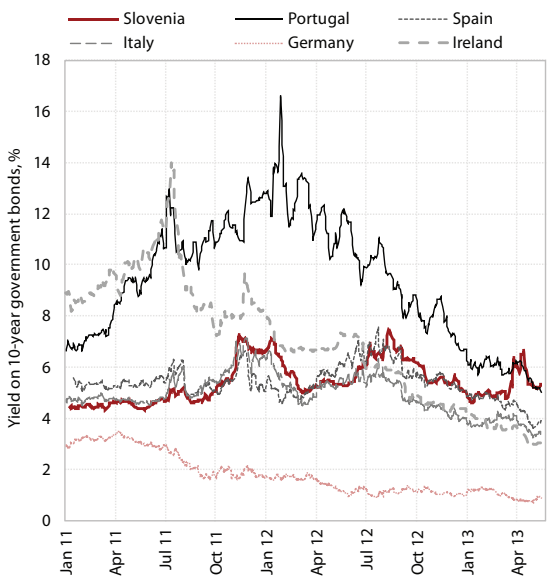
Borrowing costs rose last year as debt continued to increase and the macroeconomic environment deteriorated, with domestic factors coupling with a general tightening of the euro bond market midway through the year. Since March 2012 the yields on Slovenian government bonds have hovered at a relatively high level, roughly in line with the yields of the most vulnerable euro area countries, with the yield curve driven by specific domestic factors as well as factors common to the euro area. The yields on Slovenian 10-year bonds were heavily affected mid-year by worsening problems of the domestic banking sector, recurrent suggestions that the country might have to request a bailout and, towards the end of the year, political instability. In August all the major rating agencies downgraded Slovenia and retained negative outlooks. The yields were also driven by the general situation on international financial markets. Through autumn the situation deteriorated and confidence in the majority of euro area countries worsened. The deepening of the crisis in Spain and the increasing likelihood of it having to request a bailout propelled yields higher in June for all vulnerable euro area countries, including Slovenia. In September ECB action and EU measures to deepen the integration of the EMU and introduce common bank supervision (see also Chapter 1) resulted in renewed optimism on European financial markets, contributing to a fall in the yield on Slovenian 10-year government bonds to about 5% at the end of the year. The yields on Slovenian euro-denominated bonds rose again towards the end of March 2013, when increased uncertainty over the resolution of the debt and banking crisis in Cyprus began driving up the yields of all vulnerable euro area countries. The impact on Slovenian bonds was even more pronounced, as speculations resurfaced that it might request a bailout and the European Commission placed Slovenia among the countries with excessive macroeconomic imbalances. In the first half of April the yield hovered at over 6.5%; it then declined, but remains relatively high. Rating agencies downgraded Slovenia's sovereign debt again: S&P by one notch from A to A- in February, with the outlook changed to stable from negative, Moody's by two notches from Baa2 to Ba1 (to speculative grade) at the end of April, and Fitch by one notch to BBB+ with a negative outlook in mid-May. The downgrades were prompted by the weakening of the banking system and the growing debt, but the agencies also highlighted uncertain economic growth prospects.

Table 15: **Ratings (May 2013) and changes between 2008 and 2013**

Country	Agency	As of May 2013	Change 2013/2008	Latest rating change
Greece	Fitch	B-	↓10*	May 2013
	Moody's	C	↓16	Mar 2012
	S&P	B-	↓10*	Dec 2012
Ireland	Fitch	BBB+	↓7	Jan 2012
	Moody's	Ba1 (neg)	↓10	Jul 2011
	S&P	BBB+	↓7	Apr 2011
Portugal	Fitch	BB+ (neg)	↓8	Nov 2011
	Moody's	Ba3 (neg)	↓10	Feb 2012
	S&P	BB	↓8	Jan 2012
Cyprus	Fitch	B (neg)	↓11	Feb 2013
	Moody's	Caa3	↓18	Jan 2013
	S&P	CCC	↓16	Mar 2013
Spain	Fitch	BBB (neg)	↓9	Jun 2012
	Moody's	Baa3 (neg)	↓12	Oct 2012
	S&P	BBB- (neg)	↓8	Jun 2012
Italy	Fitch	BBB+ (neg)	↓4	Jan 2012
	Moody's	Baa2 (neg)	↓6	Jul 2012
	S&P	BBB+ (neg)	↓3	Jan 2012
Slovenia	**Fitch**	**BBB+ (neg)**	**↓5**	**Maj 2013**
	Moody's	**Ba1 (neg)**	**↓8**	**Apr 2013**
	S&P	**A-**	**↓4**	**Feb 2013**

Sources: Standard & Poor's, Moody's, Fitch, 2013.
Notes: * In December 2012 Greece was first downgraded to SD (selective default), whereupon its rating was upgraded to B-; neg: negative outlook; change: cumulative rating downgrade during the period..

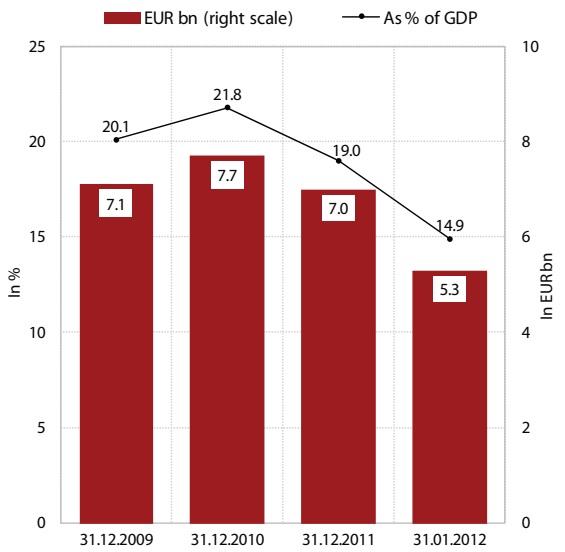
Figure 12: **Yield on 10-year government bonds**



Sources: Bloomberg, IMAD calculations.

Publicly guaranteed debt is one of the risk factors for an increase in public debt over the medium and long term. Having risen significantly in the last three years as a result of government guarantees to mitigate the impact of the financial crisis, publicly guaranteed debt declined by EUR 1.6 bn last year to EUR 5.3 bn or 14.9% of GDP (2011: 19% of GDP). The decline was largely (EUR 1.4 bn) the result of the expiry of a guarantee scheme for domestic financial institutions, which was introduced in 2009 in the form of EUR 2 bn in government guarantees for the borrowing of domestic banks in the rest of the world. The value of called guarantees edged higher in the last two years, almost entirely due to the calling of guarantees granted to legal entities (other than financial institutions) to mitigate the impact of the financial crisis, but it remains relatively low (EUR 23.5 m in 2012). Nevertheless, the total outstanding amount and the likelihood of government guarantees being called is a major factor in shaping the mood of financial investors, and can affect borrowing costs.

Figure 13: **Publicly guaranteed debt in Slovenia (as % of GDP, EUR bn)**



Source: MF.

Table 16: **Paid government guarantees**

	2009	2010	2011	2012
Paid government guarantees, EUR million	1.1	8.3	20.8	23.5

Source: MF.

Slovenia is still in the lower half of EU countries in terms of the debt-to-GDP ratio, but the debt increase since the outbreak of the crisis has been significantly faster than in the majority of other countries. Since 2008 the debt-to-GDP ratio has thus increased more only in the countries facing major fiscal problems and/or recession (Ireland, Portugal, Greece, Spain, Cyprus, UK; see Chapter 1).

5. Long-term sustainability of the public finances: age-related challenges

The long-term sustainability of the public finances depends on the structural balance between revenue and expenditure, and a relatively stable macroeconomic environment free of excess imbalances. Given the existing structural weaknesses of the Slovenian economy, especially in competitiveness and the relatively underdeveloped financial system, and the changes in the demographic structure of the population, it will be impossible to achieve fiscal consolidation in the coming years and against the backdrop of the persistent economic crisis without adjustments.

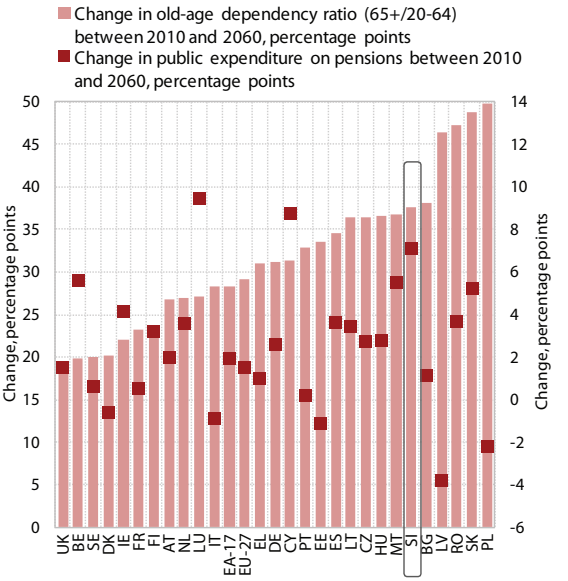
The key long-term fiscal policy challenge is to maintain the sustainability of public finances as the population ages. Eurostat population projections (EUROPOP2010) show that population aged over 65 will almost double by 2060. The old-age dependency ratio,[45] which stood at 25.6 in 2010, is projected to surge to 63.2 by 2060 (Figure 14). Moreover, EUROPOP2010 projects high migration flows for Slovenia. For example, for 2010, when moderate negative net migration[46] was recorded, it projected net migration of 11 thousand, with the projections to 2060 averaging 6 thousand migrations per year. Actual net migration between the initial year of the projection in 2010 and 2012 averaged fewer than 800 per year. Since Slovenia is primarily a destination for working-age immigrants, the ageing problem will worsen if the assumption about such high migration is not realised, as fewer immigrants (assuming other variables are unchanged) in the total population translates into fewer working-age persons and a higher old-age dependency ratio. The emigration of young Slovenian citizens (SURS figures suggest that the number of emigrants last year was double that in the previous year) represents yet another risk of a higher old-age dependency ratio.

The rapid increase in the share of the elderly population will increase age-related expenditure in the years ahead, especially pensions, and the new pension law still does not ensure long-term sustainability. The latest long-term projections of

[45] The number of the elderly (over 65) relative to the working age population (20-64).
[46] Immigrants less emigrants.

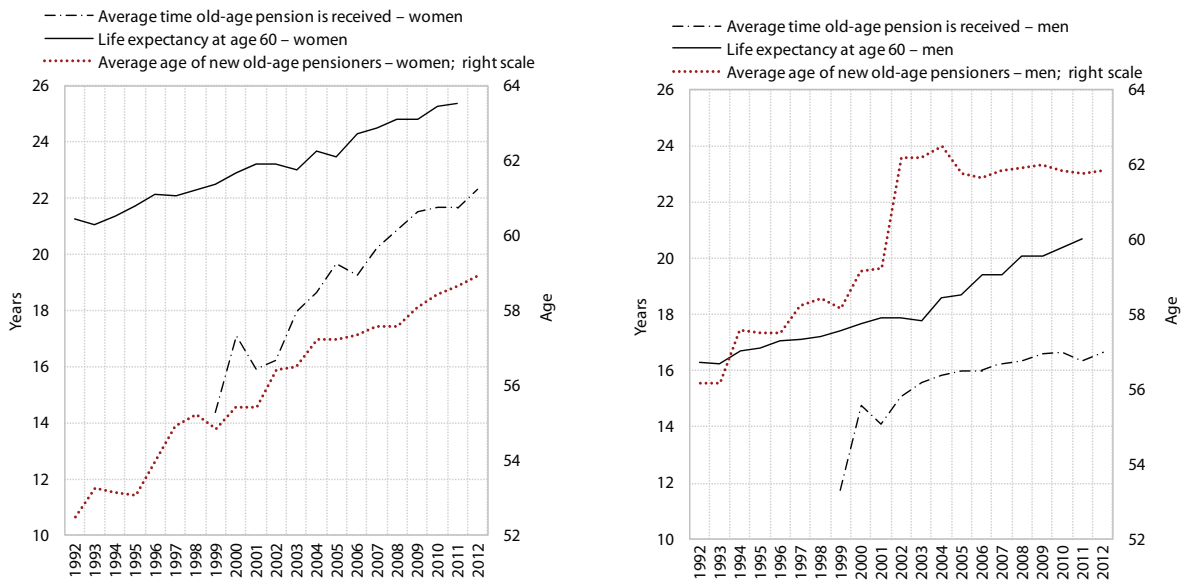
age-related expenditure[47] for the 2010-2060 period, which the European Commission released in May 2012,[48] show that Slovenia remains at the top of the EU in terms of the increase in pension expenditure (which represents the bulk of age-related expenditure) in the period to 2060 (along with Cyprus and Luxembourg; see Figure 15). In December 2012, after the report was issued, Slovenia passed a pension reform (see Box 2), but that will not be enough to bring down expenditure in the longer term. Pension expenditure as a share of GDP is forecast to be about 1 percentage point lower than under the old law. In 2060 pension expenditure is projected at 17.0% of GDP, compared with 18.3% in the previous forecast (Figure 16). Expenditure will remain below 12% of GDP until 2020, whereupon it will start rising more rapidly.[49] The new pension system therefore does not ensure long-term fiscal sustainability, as the recent changes to the pension system will only have a short- to medium-term positive impact on fiscal sustainability. Additional changes in the direction of linking pension parameters more closely to rising life expectancy will be required (Figure 15 shows a comparison between selected pension parameters for men and women in the past), which the European Commission once again highlighted in its recommendations on the National Reform Programme 2013.[50]

Figure 14: **Change in old-age dependency ratio and public pension expenditure between 2010 and 2060**



Source: Ageing report 2012.

Figure 15: **Selected pension parameters, comparison between men and women**

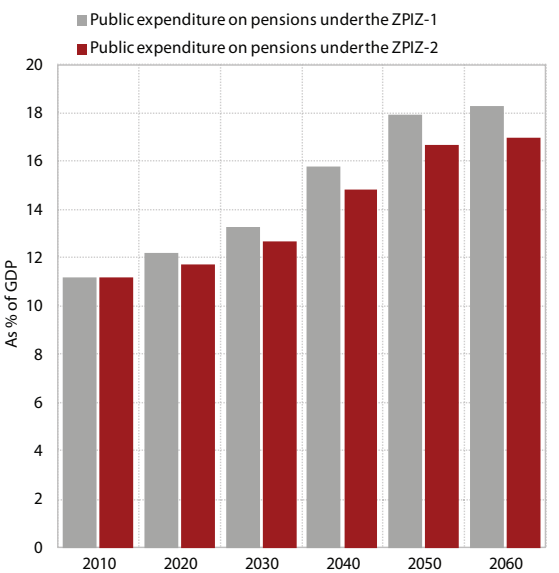


Sources: Eurostat, Pension and Disability Insurance Institute.

[47] Expenditure on pensions, health care, long-term care, education and unemployment benefits.
[48] The 2012 Ageing Report: Economic and budgetary projections for the 27 EU Member States (2010–2060), European Commission, 2012. Accessible at: http://ec.europa.eu/economy_finance/publications/european_economy/2012/2012-ageing-report_en.htm.
[49] Country Fiche on Pension Projections. Update for the Peer Review, April 2013.
[50] Recommendation for a Council Recommendation on Slovenia's 2013 national reform programme and delivering a Council opinion on Slovenia's stability programme for 2012-2016, European Commission, May 2012.

That Slovenia has problems in particular in ensuring the long-term sustainability of public finances was also highlighted in the latest Stability Report.[51] In the report the European Commission notes that fiscal trends in Slovenia are not critical in the short term, but the country has high sustainability risk in the medium and long term, primarily as a result of age-related expenditure, which will require a greater fiscal effort. This is illustrated by the values of the S1[52] and S2[53] indicators of fiscal stability, which measure the size of the required budgetary adjustment to ensure the sustainability of public finances. According to estimates, assuming unchanged policies Slovenia's public debt will exceed 60% of GDP by 2014, swelling to 75.5% by 2020 and as much as 105.5% by 2030. Slovenia should thus adopt long-term consolidation measures to the tune of 7.5 GDP percentage points in the structural primary balance in order to close the fiscal gap according to the S2 indicator (EU-27 average: 2.6 percentage points). The gap is widening primarily as a result of long-term age-related expenditure, most notably pensions (4.6 percentage points). Since these forecasts were made prior to the pension reform, it is thought that the indicators will improve slightly, but the improvement will not be sufficient to pull Slovenia out of the risk group.

Figure 16: **Public expenditure on pensions under the old (ZPIZ-1) and new laws (ZPIZ-2)**



Source: Country fiche, April 2013; Ageing report 2012..

[51] Fiscal Sustainability Report, 2012, European Economy 8/2012, European Commission, 2012. Accessible at: http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-8_en.pdf..

[52] The fiscal adjustment required for compliance with the Stability and Growth Pact criterion (60% of GDP) by 2030.

[53] Compliance with intertemporal budget constraint over an indefinite period, e.g. matching of current and future revenue to current expenditure, comprising outstanding government debt and future expenditure.

The persistent economic crisis has further worsened the prospects for managing the sustainability of public finances against the backdrop of an ageing population. The adverse situation on the labour market is reducing the number of payers of social security contributions even as the number of pensioners is increasing. Furthermore, the share of the population with supplementary pension insurance is still too low, and the average premiums are relatively modest. The number of people paying into supplementary pension insurance will probably not increase for the duration of the economic crisis. There is also the probability of the crisis lengthening and deepening, which will reduce GDP compared with the benchmarks used in the calculations, and will raise expenditure as a share of GDP, requiring additional measures to ensure the financing of pensions.[54] This gives added urgency to larger systemic adjustments in pension, health care, long-term care and labour market policies.

[54] Ministry of Finance calculations based on data on actual GDP until 2012 already indicate a higher relative level of pension expenditure than European Commission projections (Stability Programme 2013).

Box 2: **Changes to the pension law* and expenditure trends in the first months of 2013**

The new pension law equalises the retirement criteria for men and women. The retirement age and the qualifying years (pensionable service) for old-age pensions were equalised for both sexes, which is in line with the longer life expectancy of women and the resulting extension of the number of years people can expect to receive pensions. Women whose right to an old-age pension expired in 2012 received pensions for an average of 22 years and 4 months, while for men the average figure was 5 years and 8 months less (Figure 15). However women's pensions were about a tenth lower on average, as they averaged 4 qualifying years fewer than men. Under the new law, individuals will qualify for old-age pensions at the age of 65 with 15 qualifying years, or at the age of 60 with 40 qualifying years without buy-back.** The retirement age can be reduced on account of child care, compulsory military service or contributions paid before the age of 18.

The period used for the calculation of the base rate is gradually being shortened, and the way pensions are indexed has also changed. The new law extends the accounting period for the calculation of the base rate from 18 to 24 years, which will be achieved in 2018 (an extension of one year per year). The old-age pension is assessed as a share of the base rate proportional to the number of qualifying years, amounting to 26% of the base rate for men and 29% for women for 15 qualifying years, rising without limitations by 1.25% for every additional qualifying year. The pension for 40 qualifying years will thus amount to 57.25% of the base rate for men and 60.25% for women.

The bonuses for postponing retirement after qualifying for early or old-age pensions are more attractive, while the maluses for an early exit from the labour market are slightly higher than before. Individuals qualify for early retirement at the age of 60 and with 40 qualifying years (including buy-back), but in this case the law stipulates a permanent reduction of the pension by 0.3% for each month short of the normal retirement age. Partial retirement is also possible under the law (for at least half the standard working hours) and the pension is (proportionately) determined as a share of the early or old-age pension increased by 5% until the age of 65. Postponing retirement after the criteria have been met earns individuals bonuses in the amount of 1% for every 3 months of work beyond the meeting of the retirement criteria set out in Article 27(4) of the law (60 years of age and 40 qualifying years excluding buy-back) or Article 27(5) (transitional period referred to in note**) for a maximum period of three years (maximum increase of 12%). Individuals postponing retirement after the criteria have been met and paying contributions in unchanged amounts are eligible for 20% of early or old-age pension while they remain active, but only until the age of 65.

Pensions are indexed on the so-called Swiss formula. Indexation is carried out each year in February on the basis of a formula comprising the growth in the average gross wage (60%) and the average growth in consumer prices in the previous year (40%), but the increase cannot be lower than half the growth in consumer prices.

In the first four months of this year pension expenditure rose at a slightly faster pace than in the same period last year, a consequence of a jump in old-age retirements before the new law entered into force at the beginning of the year. Expenditure rose by 2.3% in nominal terms and 0.2% in real terms. The entry into force of the new pension law led to an increase in early 2013 in the number of old-age pensioners (up 4.9% year-on-year in the first four months) who qualified for retirement before the end of last year. By April the number of old-age pensioners was up by almost 19,500 on the previous year (the year-on-year increase during the first four months of last year was 14 thousand). For the same reason, increased retirements and growth in expenditure are not expected in the coming months. Expenditure on all types of pensions*** totalled EUR 1,381.9 m in the first four months of the year, an increase of EUR 31.7 m over the previous year.

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*Pension and Disability Insurance Act (ZPIZ-2), Official Gazette of the Republic of Slovenia, No. 96/2012; Ministry of Labour, Family and Social Affairs - Modernizacija pokojninskega sistema (ZPIZ-2) (Modernisation of the pension system), available at http://www.mddsz.gov.si/. The act entered into force on 1 January 2013.

** These criteria are being phased in over a transitional period. For retirement with at least 15 qualifying years, the retirement age for women will rise from the baseline 63.5 years by half a year, reaching 65 in 2016. For retirement with 40 qualifying years excluding buy-back (Article 27(5)) the retirement age will rise by four months each year reaching the target in 2018 for men and in 2019 for women; in 2013 men will be able to retire at the age of 58 years and 4 months given 40 qualifying years (excluding buy-back) and women at the age of 58 with 38 qualifying years and 4 months.

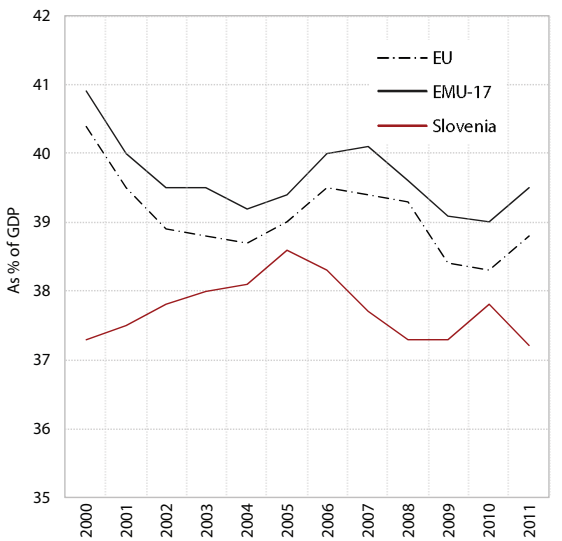
*** According to the PDII balance sheet, which includes the following types of pensions: old-age, disability and family pensions, farmer's pensions, veteran's pensions, pensions claimed in other republics of the former SFRY, pensions transferred to other republics of the former SFRY, pensions transferred abroad, annual pension allowance, other pensions.

6. Tax changes in the EU and Slovenia

The decline in the ratio of taxes and contributions to GDP ended in the EU in 2011. The ratio of total taxes and contributions to GDP, which had started to decline in the EU overall after the outbreak of the economic and financial crisis in 2008, increased for the first time in 2011, and preliminary estimates indicate that the increase continued in 2012. Most countries mitigated the decline in tax revenue as the macroeconomic situation deteriorated in that period with proactive tax instruments in order to cut budget deficits.

In Slovenia taxes and contributions began to decline as a ratio to GDP prior to the start of the economic crisis, three years before the same process in the EU overall. Following the convergence of the tax system before EU accession, Slovenia came very close to the EU average in 2005 in terms of the ratio of taxes and contributions to GDP. After 2005 the ratio declined to significantly below the EU average. The decline in what had been a favourable macroeconomic environment was largely the result of tax reforms introduced before the crisis. All tax changes had been geared towards cutting taxes, which was favourable in terms of easing the tax burden on the economy, but was not coupled with measures to restructure and sustainably reduce expenditure. During the economic crisis the public finances deteriorated sharply. In previous years Slovenia mitigated the impact on tax capacity predominantly via changes to excise duties and environmental taxes, but it employed fewer proactive tax measures than other EU countries; in certain segments additional tax cuts were made (cut in the corporate income tax rate, increases in allowances) that had a direct negative impact on fiscal consolidation.

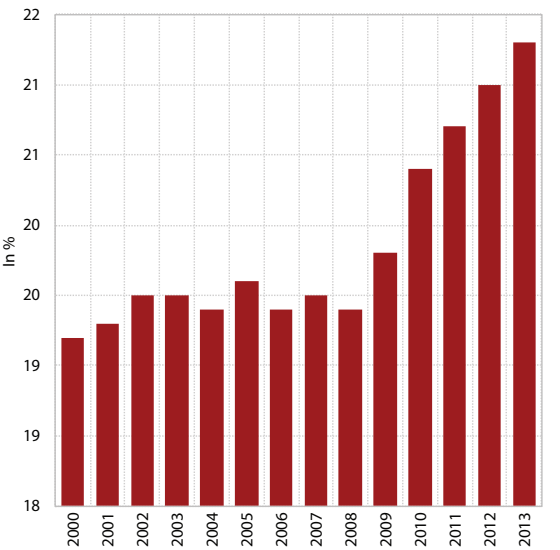
Figure 17: **Total taxes and social security contributions, as % of GDP**



Source: Taxation trends in the European Union, 2013 Edition.

During the economic and financial crisis countries have resorted mainly to measures to increase taxes on consumption,[55] which have a more moderate impact on economic growth compared with other taxes. In the EU overall there has been a noticeable trend since 2008 to raise the standard VAT rate. Between 2008 and 2013, VAT rates rose in over half of all EU countries. The average standard rate increased by 1.8 percentage points in this period, and is projected to hit 21.3% in 2013 according to European Commission forecasts.

Figure 18: **Average standard VAT rate in the EU**



Source: Taxation trends in the European Union, 2013 Edition.
Note: arithmetic average

VAT rates were raised in Slovenia in 2013 too. Under the Act Amending the Republic of Slovenia Budget for 2013 and 2014 Implementation Act (June 2013), in July the standard VAT rate was raised 2 percentage points to 22% and the reduced rate was raised 1 percentage point to 9.5%. So far 17 EU countries have raised standard VAT rates.

[55] VAT accounts for the largest proportion of taxes on consumption.

Table 17: **VAT rates in EU countries, %**

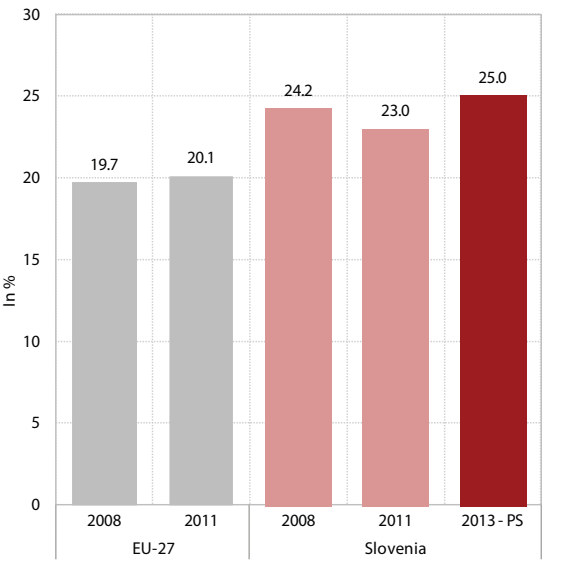
	Standard rate		Reduced rate	
	2008	2013	2008	2013
Belgium	21	*21*	6 and 12	*6 and 12*
Bulgaria	20	*20*	7	*9*
Czech Republic	19	*21*	9	*15*
Denmark	25	*25*		*-6.9*
Germany	19	*19*	7	*7*
Estonia	18	*20*	5	*9*
Ireland	21	*23*	13.5 and 4.8	*13.5 and 4.8 and 9*
Greece	19	*23*	9 and 4,5	*6.5 and 13*
Spain	16	*21*	7 and 4	*10 and 4*
France	19.6	*19.6*	5.5 and 2.1	*5.5 and 7 and 2.1*
Italy	20	*21*	10 and 4	*10 and 4*
Cyprus	15	*18*	5 and 8	*5 and 8*
Lithuania	18	*21*	5 and 9	*5 and 9*
Latvia	18	*21*	5	*12*
Luxembourg	15	*15*	6 and 12 and 3	*6 and 12 and 3*
Hungary	20	*27*	5	*5 and 18*
Malta	18	*18*	5	*5 and 7*
Netherlands	19	*21*	6	*6*
Austria	20	*20*	10	*10*
Poland	22	*23*	7 and 3	*5 and 8*
Portugal	20	*23*	5 and 12	*6 and 13*
Romania	19	*24*	9	*5 and 9*
Slovenia	20	*20*	8,5	*8,5*
Slovakia	19	*20*	10	*10*
Finland	22	*24*	8 and 17	*10 and 14*
Sweden	25	*25*	6 and 12	*6 and 12*
United Kingdom	17.5	*20*	5	*5*

Source: Taxation trends in the European Union, 2013 Edition

Adopting appropriate measures to expand the tax base for the levying of VAT remains a notable economic-policy challenge. As a result of exemptions, reduced rates, and tax evasion and avoidance, European countries actually collect only half the theoretical VAT, according to European Commission estimates. Although the comparison of actual collected VAT with theoretically calculated VAT does not take account of the lower revenue associated with reduced VAT rates,[56] it indicates that tax receipts could be raised by curbing the grey economy and with other measures to prevent tax avoidance and evasion. Similar conclusions apply to Slovenia; for 2009 SURS calculated a tax gap of EUR 330 m caused by tax evasion and avoidance compared with total tax revenue of EUR 2,838 m that year. Some EU countries have already started to introduce measures to clamp down on tax evasion and avoidance, and Slovenia is considering mandatory software monitoring of turnover this year in a bid to prevent VAT evasion.

During the crisis other taxes on consumption have also been raised in EU countries, in particular excise duties and environmental taxes. Slovenia is among those levying higher excise duties in order to raise budget revenue. Duties on all excisable products have been increasing, resulting in arise in the ratio of excise duties to GDP from 3.2% before the crisis to 4.4% in 2012, significantly above the EU average (2011: 2.7%).

Figure 19: **Implicit tax rate on consumption, as % of base**



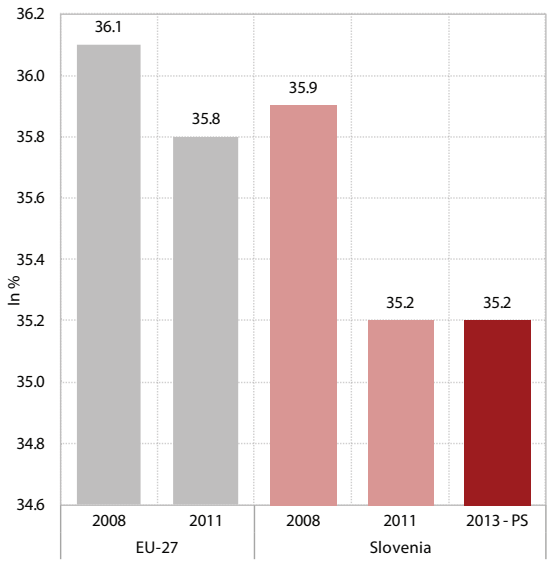
Source: Taxation trends in the European Union, 2013 Edition; 2013 figures for Slovenia calculated by IMAD.

The calculation and comparison of implicit tax rates on consumption shows that the average taxation of consumption rose in the EU between 2008 and 2011, while it declined in Slovenia but remained above the EU average. Consumption is taxed more heavily in Slovenia than in the EU on average, and the burden will increase further as VAT rises in mid-year; the estimated increase is about 25%.

[56] In this indicator the European Commission estimates theoretical VAT at the standard VAT rate (without reductions) relative to final consumption.

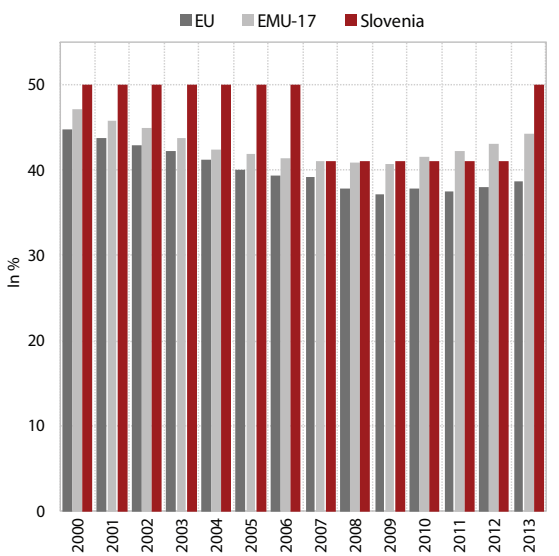
In 2011 the trend of rising taxation of labour was reversed overall in the EU. Calculations of the implicit tax rate on labour reveal a decline in the EU average in 2009 and 2010 and a slight increase in 2011. The trends are similar in Slovenia, where taxation of labour has been declining largely as a result of the phasing out of payroll tax after 2007. At the outbreak of the crisis many EU countries resorted to tax policy measures to mitigate the effects of the crisis by unburdening labour to help taxpayers while also improving competitiveness. The measures were largely targeted at increasing tax allowances for the lowest tax brackets, but the top marginal income tax rates were cut at the same time. Subsequently, the need for fiscal consolidation led some countries to raise the top marginal income tax rates again to redistribute the burden of the crisis to a greater extent to those with higher income. The average top marginal income tax rate has been increasing moderately since 2011 in the EU overall and since 2009 in the euro area. Under the ZUJF, Slovenia raised the top marginal income tax in a new fourth bracket in 2013.

Figure 20: **Implicit tax rate on labour, as % of the base**



Source: Taxation trends in the European Union, 2013 Edition; 2013 figures for Slovenia calculated by IMAD.

Figure 21: **Top marginal income tax rates, %**

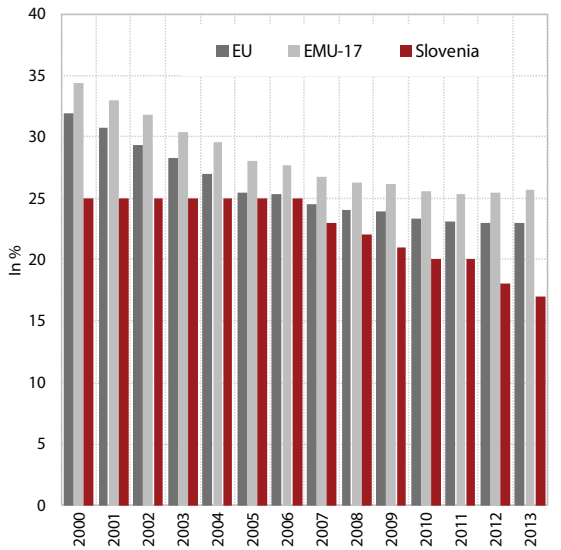


Source: Taxation trends in the European Union, 2013 Edition.
Note: arithmetic average for EU and EMU.

In 2011 the trend of rapid decline in statutory corporate income tax rates came to a halt in the EU. The rapid decline in corporate income tax rates that was a feature of the period after 1995 slowed in 2005, and came to a virtual standstill in 2010. The average corporate income tax rate in the euro area actually rose slightly in the past two years. The less-wealthy countries were the first to cut taxes in order to lure foreign investors, but other European countries subsequently followed suit as a result of convergence. The average tax rate in the EU fell to 23% in 2012 from 31.9% in 2000. Aside from changing the statutory tax rates and the tax allowance policy, many EU countries have also worked to expand the tax base, in particular via measures in connection with the recognition and restriction of tax-deductible expenses.

Slovenia is notable in Europe as a low-tax country for corporate income tax. The actual collected taxes are affected by exemptions, which are present in all countries. The statutory corporate income tax rate was below the EU average in the entire observation period (1995-2011), and has even been among the lowest in Europe in recent years. Tax allowances can significantly reduce the effective rate, which is the case across the EU, though the differences between individual countries are significant (Taxation trends in the EU 2013). Slovenia's corporate income tax rate was meant to fall further in the next two years according to current legislation, but according to the 2013 update to the Stability Programme it will remain at the 2013 level (17%).

Figure 22: **Average statutory corporate income tax rate, as % of the base**



Source: Taxation trends in the EU, 2013 Edition;
Note: arithmetic average for EU and EMU

There has been a significant push in the EU recently for revenue-side fiscal consolidation as a means of raising other taxes, in particular property taxes, which, like taxes on consumption, have a smaller impact on economic growth. Higher property taxes typically do not have a big financial impact, but their demonstration effect via taxation of the wealthier matters in a crisis. Under the ZUJF, Slovenia raised property taxes in 2013 with the introduction of additional taxes on boats, motor vehicles with bigger engines and real estate of higher value, while the introduction of a new real estate tax as of 2014 is planned in the 2013 update to the Stability Programme.

Some countries have put in place special taxes as part of fiscal consolidation efforts (Portugal, Croatia), introducing progressive taxation of all types of income for a shorter, specified period. The 2013 update to the Stability Programme sets out the introduction of a crisis tax as a contingency measure if expenditure-side measures do not have the desired impact on fiscal consolidation in 2013.

7. Assessment of fiscal consolidation

7.1. Excessive deficit procedure

In December 2009 the European Commission initiated an excessive deficit procedure against Slovenia, setting 2013 as the deadline for correcting the deficit, before extending the deadline to 2015 this year. In its October 2009 report on the general government debt and deficit, Slovenia estimated the general government deficit at 5.9%; in November 2009 the European Commission initiated an excessive deficit procedure against Slovenia under the Treaty establishing the European Community (TEC) as set out in the revised Stability and Growth Pact of 2005.[57] Based on an assessment of the public finances and the European Commission's factors for determining whether an excessive deficit has arisen,[58] the EU Council made recommendations and set 2013 as the deadline for correction, warning that the manoeuvring room for Slovenia's fiscal policy is additionally limited because of the challenges to the long-term sustainability of the public finances and the contingent liabilities arising from government guarantees. It recommended that over the 2010–2013 period Slovenia provide for an average annual structural budgetary improvement of 0.75 GDP percentage points, and outline the requisite measures to correct the excessive deficit. The recommendations stressed that fiscal consolidation should ensure a permanent improvement in the public finances and the quality thereof, and enhance potential GDP growth. The European Commission highlighted that Slovenia needs to improve the enforceability of its multi-year budget plans and improve public spending efficiency and effectiveness to make room for enhanced expenditure on research, innovation

[57] Article 104(3) of the TEC Treaty stipulates that whenever a Member State's general government deficit exceeds the reference value of 3% of GDP, the European Commission 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 than an excessive deficit does exist, it addresses the recommendations put forward by the European Commission to the Member State in accordance with Article 104(7) of the TEC. 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 a close.

[58] The assessment includes all factors affecting the realisation of fiscal policy goals: the general government debt and deficit at the start of excessive deficit procedure; indicators of external balance; the government's contingent liabilities in connection with issued guarantees, in particular for measures to stabilise the financial sector during the crisis; interest rates and yields on government bonds; medium-term changes in ageing-related general government expenditure.

and human capital creation. At the same time it needs to increase the involvement of young people and senior citizens in the labour market and to improve its functioning. In the draft Council recommendations for the correction of the excessive deficit,[59] the European Commission proposed an extension of the deadline for the correction of the deficit to 2015 (Box 4).

The 2012 update to the Stability Programme (SP2012) of April 2012 laid out measures to correct the excessive deficit in accordance with European Commission recommendations. Following a renewed failure in 2011 to achieve the planned correction of the deficit, primarily as a result of a worsening economy and high expenditure on recapitalisation (see also EI 2012, Chapter 9.1), last year's Stability Programme put forward more ambitious measures in order to meet the excessive deficit procedure commitments in 2013. The planned fiscal consolidation was based predominantly on expenditure cuts, though measures were also planned to improve the efficiency of revenue collection and the quality of revenue, and tax allowances were introduced for R&D and investment with a view to stimulating economic activity. In contrast to previous years, some of the measures in the SP2012 were based on passed legislation and confirmed agreements,[60] while only to a smaller extent was there a reliance on interventions in the flexible portion of the budget. The measures nevertheless included linear expenditure cuts in some segments, and were not sufficiently underpinned by a structural approach to the streamlining of expenditure (see also EI 2012, Chapter 9.2.2). In last year's Stability Programme the deficit was forecast to narrow by about EUR 1 bn, to 3.5% of GDP (2.9 percentage points less than in 2011).

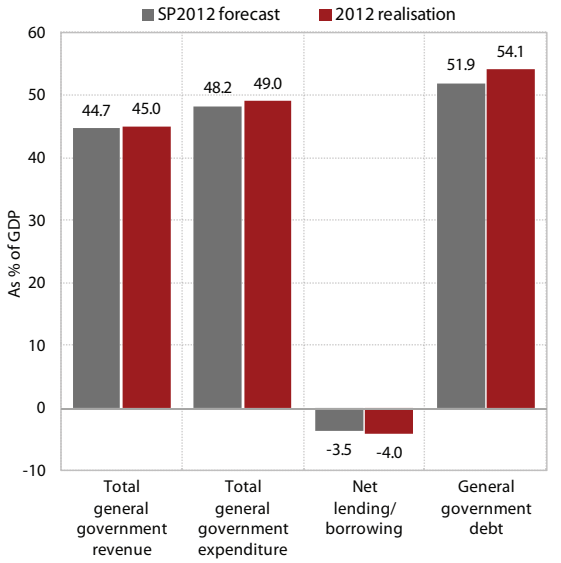
Box 3: **Council opinion on the 2012 update to the Stability Programme and recommendations** [61]

The Council opinion on the updated Stability Programme for the 2012-2015 period (24 July 2011), which is based on the European Commission assessment, states that the programme plans a broadly appropriate adjustment towards the medium-term target, and an annual pace of progress towards the medium-term target in line with the 0.5% benchmark set in the Stability and Growth Pact, while growth in government expenditure, taking account of discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact. The macroeconomic scenario underpinning the budgetary forecasts in the programme is assessed as optimistic compared with European Commission's 2012 spring forecasts. The opinion highlights that additional efforts will have to be made in 2013 to achieve the recommended consolidation over the entire period. Taking into account the current policies and projections, the medium-term objective is said to not ensure sufficiently rapid progress towards long-term stability. The opinion also highlights risks that the deficit outcomes could be worse than targeted, due to (i) a lack of specification of the measures foreseen, in particular for the 2014-15 period; (ii) a track record of primary current expenditure over-runs; (iii) a decline in revenue given the relatively optimistic macroeconomic scenario and the uncertainty surrounding the impact of the recently decided tax measures; and (iv) possible additional capital support operations and calling of guarantees. According to the Council opinion, Slovenia's medium-term budgetary framework and expenditure rule, as defined in last year's programme, remain insufficiently binding and insufficiently focused on meeting the medium-term target and securing long-term sustainability.

Based on this opinion, the Council recommended that Slovenia implement the 2012 budget and reinforce the budgetary strategy for 2013 with sufficiently specified structural measures, standing ready to take additional measures in order to ensure a correction of the excessive deficit in a sustainable manner and the achievement of the structural adjustment specified in the Council recommendations under the excessive deficit procedure. Thereafter it is to provide for a sufficient structural fiscal effort to make progress towards the relevant medium-term target for the budgetary position, including the expenditure benchmark. It is to enhance the medium-term budgetary framework, including the expenditure rule, by making it more binding and transparent. The Council further recommended that Slovenia take urgent steps to ensure the long-term sustainability of the pension system, while preserving the adequacy of pensions, by: (i) equalising the statutory retirement age for men and women; (ii) ensuring an increase in the effective retirement age, including linking the statutory retirement age to life expectancy; (iii) reducing early retirement possibilities; and (iv) reviewing the indexation system for pensions. It is to increase the employment rate of older workers, partly by further developing active labour market policies and lifelong learning measures.

[59] ec.europa.eu/europe2020/pdf/nd/edp2013_slovenia_sl.pdf
[60] Agreement on measures related to wages, benefits and other public sector earnings for fiscal consolidation for the period between 1 June 2012 and 1 January 2014, and ZUJF.
[61] Council Recommendation on Slovenia's 2012 national reform programme and a Council Opinion on Slovenia's stability programme for 2012-2015, Official Journal of the EU, 2012/C 219/23; 24 July 2012.

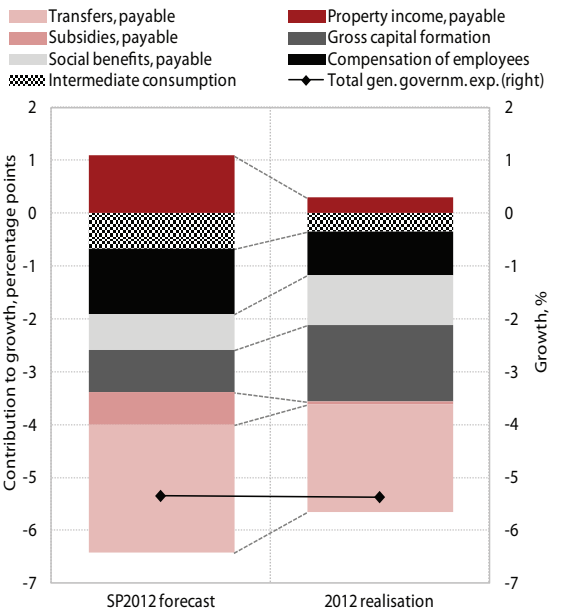
Figure 23: **Realisation of general government debt and deficit in 2012 compared with SP2012 forecasts**



Source: SURS: main aggregates of the general government, April 2013, Stability Programme (2012 Update)

A slightly higher deficit in 2012 relative to the projections in the SP2012 was primarily the result of unbudgeted specific transactions in the amount of 0.4% of GDP and deviations from the planned revenue structure. In 2012 the realised general government deficit and debt (EUR 1.42 bn and EUR 19.2 bn respectively) were slightly higher than forecast in the SP2012 (EUR 1.25 bn and EUR 18.5 bn) and roughly in line with the notification of September 2012. The general government deficit was EUR 171 m or 0.5 GDP percentage points higher than projected in last year's Stability Programme, and roughly in line with the SURS autumn estimate in the excessive deficit procedure (see Table 15). The key factor in the differences were specific transactions (one-off factors) in the amount of EUR 134 m (0.4% of GDP), which are shown in the deficit calculation as current capital transfers. Specifically, these transactions involved coverage of losses at several government-owned companies including recapitalisation, recognition of receivables at government-owned companies, super dividends[62] and the payment of called government guarantees. Excluding these one-off transactions, the general government deficit would have been 3.6% of GDP in 2012. Revenue was only marginally lower than planned in the SP2012 (by EUR 27 m,[63] which includes a lower estimate of taxes as a result of lower tax settlements, corporate income tax in particular). Deviations from the targets were slightly more pronounced on the expenditure side (EUR 126 m higher), where there were also differences between the forecast structure and the realised structure. Compensation of employees and intermediate consumption expenditure were significantly higher than forecast (by EUR 380 m in total). Expenditures on social benefits (by EUR 70 m), interest (by EUR 144 m),[64] subsidies (by EUR 106 m) and investment (by EUR 90 m) were lower than projected. A larger decline in economic activity (-2.3%) than forecast in the SP2012 (-0.9%) did not significantly contribute to a wider deficit, as GDP at current prices was only EUR 175 m or 0.5% lower. The debt-to-GDP ratio was 2.2 percentage points higher than the SP2012 forecast owing to the wider primary deficit (interest expenditure was 0.4 percentage points of GDP lower than forecast) and additional borrowing to pre-finance the payment of principal this year (see Chapter 4).

Figure 24: **Nominal revenue growth, %, and contributions by category, percentage points**



Source: SURS: Main aggregates of the general government sector, April 2013, Stability Programme (2012 Update).

[62] A dividend that exceeds the current earnings of a publicly owned company and is shown as a one-off event (EUR 51 m last year).
[63] Lower actual GDP at current prices relative to the projections in the SP2012 reduced revenue by 0.1 percentage points.

[64] Interest is included under the item "property income, payable" and had already been revised downwards from the forecasts in the SP2012 by the supplementary budget for 2012 adopted in May 2012.

Table 18: **Comparison of notifications under the excessive deficit procedure, September 2012 and April 2013, EUR m unless stated**

	September 2012		April 2013	
	2011	2012	2011	2012
Deficit by cash flow	**-1,564.1**	**-1,217.9**	**-1,564.1**	**-1,122.8**
Corrections for financial transactions	4.8	*15.9*	4.8	*42.2*
Accounting corrections	-247.8	*-103.6*	-238.2	*-144.1*
Revenue	-12.6	*-120.8*	-3.1	*-145.3*
Expenditure	-235.2	*17.1*	-235.2	*1.2*
Deficit/surplus of other general government units	-143.4	*-93.1*	-143.5	*-74.0*
Other corrections	-356.9	*-99.6*	-356.9	*-119.0*
General government deficit	**-2,307.4**	**-1,498.3**	**-2,297.9**	**-1,417.7**
GDP, EUR m	36,172.0	*35,700.4*	36,172.0	*35,466.4*
Deficit as % of GDP	**-6.4**	**-4.2**	**-6.4**	**-4.0**

Source: Report on the general government deficit and debt (October 2012 and April 2013)

7.2 Assessment of the consolidation of public finances in the 2013 update to the Stability Programme

7.2.1 Macroeconomic assumptions in the consolidation of public finances

The economic growth forecast for the entire programming period until 2016 is significantly lower than in last year's Stability Programme. The key reasons for this include the less favourable domestic economic situation (larger constraints on access to financing, deleveraging of companies and banks, a deterioration in the situation on the labour market), which is consequently holding back capital formation and private consumption. The international situation is also less favourable than forecast last year, for this year and also for the years ahead. In 2012 GDP was already EUR 0.2 bn lower than forecast in last year's Stability Programme. Given the lower GDP in the reference year and the weaker outlook for the period ahead, GDP will be EUR 1.3 bn lower than forecast in last year's Stability Programme, the gap widening to EUR 2.8 bn in 2015.

7.2.2 Assessment of the 2013 update to the Stability Programme

The 2013 update to the Stability Programme (SP2013) projects a one-year delay in the implementation of the commitment under the excessive deficit procedure. According to the SP2013 projections, the general government deficit will reach

Table 19: **Changes in macroeconomic assumptions for the consolidation of public finances in the SP2012 and SP2013**

	2010	2011	2012	2013	2014	2015	2016
GDP, EUR bn (SP2012)	35.4	35.6	35.6	36.6	38.1	*39.6*	
GDP, EUR bn (SP2013)	35.6	36.2	35.5	35.3	35.7	*36.8*	*38.1*
Difference SP 2013–SP 2012, EUR bn	0.2	0.5	-0.2	-1.3	-2.3	*-2.8*	
Nominal GDP growth, % (SP2012)	0.3	0.6	0.0	2.7	4.0	*4.1*	
Nominal GDP growth, % (SP2013)	0.1	1.6	-2.0	-0.6	1.4	*3.0*	*3.5*
Difference SP 2013–SP 2012, percentage points	-0.2	1.0	-2.0	-3.3	-2.6	*-1.1*	
Real GDP growth, % (SP2012)	1.4	-0.2	-0.9	1.2	2.2	*2.2*	
Real GDP growth, % (SP2013)	1.3	0.6	-2.3	-1.9	0.2	*1.2*	*1.6*
Difference SP 2013–SP 2012, percentage points	-0.1	0.8	-1.4	-3.1	-2.0	*-1.0*	

Sources: SURS: Main aggregates of the general government sector, April 2013, Stability Programme (2012 Update), Stability Programme (2013 Update), Spring forecast of economic trends 2012, IMAD, Spring forecast of economic trends 2013, IMAD.
Note: The figures do not necessarily sum fully due to rounding.

almost 7.9% of GDP in 2013, of which 3.7% of GDP relates to one-off factors (bank recapitalisation); the deficit will narrow to 2.6% of GDP in 2014 and will then approach a balanced position (-0,5% of GDP in 2017). This entails a one-year delay in the implementation of the commitment to reduce the general government deficit below 3% of GDP, the argumentation for which is the significant change in the macroeconomic situation. The reduction in the structural deficit in the period until the implementation of the commitment will average 0.7 percentage points per year, close to the European Commission requirement in the excessive deficit procedure (0.75 percentage points per year on average). The SP2013 also envisages balanced-budget amendments to the constitution to ensure compliance with the requirement in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (see Chapter 1), which the National Assembly approved in May 2013. The constitutional fiscal rule will be upgraded with an implementing law and an updated Public Finances Act to adjust the budget procedure.

The fiscal consolidation measures outlined in this year's Stability Programme include the continuing implementation of last year's measures, and additional expenditure-side and, in particular, revenue-side measures. On the *expenditure side* the SP2013 envisages further restrictions on expenditure on public sector wages (in addition to the impact of last year's ZUJF), which was achieved via an agreement with public sector trade unions[65] (May 2013) and will start affecting the level of compensation of employees this year. There will also be continuing measures to curb pension expenditure (the existing reduction in the recreation allowance, a freeze on pension indexation) and social transfers, which will involve reducing and restricting certain cash benefits. Subsidies will also gradually be cut until the end of the programming period. The Stability Programme further stipulates that the supplementary budget for 2013 (scheduled for July 2013) will curb expenditure on goods and services, and investment (compared with the current budget). However, substantial growth in investment expenditure is forecast for next year, and interest expenditure will increase throughout the programming period. On the *revenue side* a rise in VAT rates is planned, and several new taxes and duties are to be introduced. The standard VAT rate will rise by 2 percentage points and the reduced rate by 1 percentage point on 1 July 2013. In 2014 the introduction of a real estate tax is planned, replacing the current system of taxation of real estate (the fee for the use of building land and property tax), which is expected to improve the efficiency of capture. A tax on lottery ticket sales and excise duties on certain sweet beverages will be introduced in mid-year, and an increase in court fees is planned. Furthermore, the gradual reduction in corporate income tax approved last year is to be stopped at 17%. In health care additional emergency measures are planned to expand the contribution base for different categories of insured persons under the principle of "all income counts", and a minimum contribution rate for the self-employed will be set. In addition to these permanent measures, the SP2013 refers to a contingent, temporary measure in the form of a crisis tax on personal income that would take effect on 1 January 2014 in the event of additional measures to reduce expenditure at a comparable rate not being agreed this year. The overall impact of the revenue-side discretionary measures is highest in 2014, when it would amount to close to 2% of GDP should the crisis tax be introduced. The government also plans to place greater emphasis on the efficiency and effectiveness of the collection of existing duties, and on measures to crack down on the grey economy.

Additional measures will be needed to underpin the structural consolidation target to a larger extent with permanent expenditure cuts. The assessment in the SP2013 is that the measures distribute the fiscal effort to cut the deficit over the programming period roughly evenly between expenditure-side and revenue-side measures, which is a departure from the government's objective of spending cuts accounting for two-thirds of the consolidation effort and discretionary revenue-side measures for one-third. The Stability Programme thus states that new expenditure-side measures are required.

The SP2013 also outlines economic stimulus measures, which will have a positive medium-term impact on public finances, provided that they are successfully implemented. The key measures include strengthening bank stability, and corporate deleveraging and restructuring. Financing for these measures, in particular in the banking sector, will increase expenditure this year by 3.7% of GDP (recapitalisations already carried out via the conversion of hybrid bonds into equity in the amount of EUR 420 m and direct bank recapitalisation after the transfer of non-performing loans to the Bank Assets Management Company [BAMC], estimated at EUR 900 m), with these one-off measures expected to directly impact expenditure in subsequent years mainly via higher interest expenditure. The planned restructuring of the banking system via the BAMC will increase general government debt, as the purchase of non-performing bank loans will involve the issue of government-guaranteed BAMC bonds, with the

[65] Agreement on additional measures related to wages and other public sector labour costs for fiscal consolidation for the period between 1 June 2012 and 1 January 2014.

total amount of the guarantees estimated at EUR 4 bn. Debt will consequently increase by up to 11.4% of GDP, and compensating for this one-off impact in the subsequent years will depend on the dynamics of the disposal or liquidation of the acquired assets. Other economic stimulus measures listed in the SP2013 focus on a systematic approach to corporate deleveraging. Deleveraging is supposed to be based on three approaches: (i) an improvement in the bankruptcy framework, the legislative framework for financial restructuring (insolvency legislation, court-mandated debt restructuring), and a new out-of-court procedure for deleveraging regulated by a special law; (ii) selective measures via the BAMC and the government to support individual economically viable companies with successful business models; (iii) an influx of fresh capital from the private sector via privatisation. Additionally, measures are planned to improve the governance of government-owned companies, and several specific privatisations are due to begin before the summer. The impact of the corporate restructuring and deleveraging measures is not explicitly evaluated in the SP2013, but their implementation is the key to Slovenia's overall standing on the international financial markets, and to renewed growth in the coming years and the attendant improvement in borrowing terms. Failing that, deficit borrowing and debt refinancing would be severely restricted, which could jeopardise the implementation of other objectives set out in the SP2013.

Box 4: **Draft Council recommendation for the correction of the excessive deficit in 2013**

On 29 May, 2013 the European Commission released the recommendation for a Council recommendation with a view to bringing an end to the situation of an excessive government deficit in Slovenia, in which it put forward the following recommendations, pending confirmation by the Council, based on an analysis of fiscal trends and projections from its spring forecast:

(1) Slovenia should bring to an end the present excessive deficit by 2015.
(2) Slovenia should reach a headline general government deficit target of 4.9% of GDP in 2013 (3.7% of GDP without 1.2% of GDP one-off expenditure to recapitalise the two largest banks), 3.3% of GDP in 2014 and 2.5% of GDP in 2015, which is consistent with an annual improvement of the structural balance of 0.7% of GDP in 2013, 0.5% of GDP in 2014 and 0.5% of GDP in 2015, in order to bring the headline government deficit below the 3% of GDP threshold by 2015, based on the Commission services' updated 2013 Spring Forecast.
(3) Slovenia should rigorously implement the measures already adopted to increase mainly indirect tax revenue and reduce the public sector wage bill and social transfers, while standing ready to complement them with additional measures if their yield would prove less than foreseen or if any measure is repealed by the justice system.
(4) In addition, Slovenia should specify, adopt and implement new structural consolidation measures, on top of those already included in the Commission's updated spring 2013 forecast that are necessary to achieve the correction of the excessive deficit by 2015.
(5) The Council established the deadline [1 October 2013] for Slovenia to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No. 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.
Furthermore, the Slovenian authorities should (i) accelerate the reduction of the headline deficit in 2014 and 2015 if economic or budgetary conditions turn out better than currently expected; (ii) specify, adopt and implement structural consolidation measures which gradually decrease the current expenditure ratio to GDP, secure a lasting improvement in the general government structural balance, support growth potential of the economy including through avoiding further cuts in public investment, and gradually put the debt ratio on a downward path. To ensure the success of the fiscal consolidation strategy, it will also be important to back the fiscal consolidation with comprehensive structural reforms, in line with the Council recommendations addressed to Slovenia in the context of the European Semester and Macroeconomic Imbalances Procedure.
Beyond the report foreseen in recommendation (5), the Slovenian authorities should report on progress made in the implementation of these recommendations at least every six months, as well as in a separate chapter in the stability programmes, until full correction of the excessive deficit has taken place.

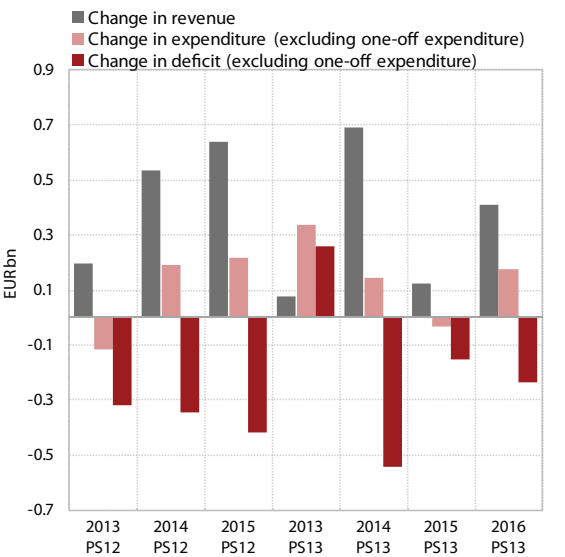
Table 20: **Comparison of revenue, expenditure and deficit in the SP2012 and SP2013, as % of GDP**

	Realisation		Forecasts								
			SP 2012 (April 2012)				SP 2013 (May 2013)				
	2011	2012	2012	2013	2014	2015	2012	2013	2014	2015	2016
Total general government revenue	***44.4***	***45.0***	***44.7***	***44.1***	***43.8***	***43.7***	***44.8***	***45.5***	***46.8***	***45.8***	***45.3***
Taxes on production and imports	14.1	14.6	14.3	14.4	*14.6*	*14.7*	14.4	15.0	*15.6*	*14.7*	*14.6*
Current taxes on income, property	8.0	7.7	8.0	7.6	*7.5*	*7.4*	7.7	7.6	*8.8*	*8.7*	*8.6*
Social security contributions	15.3	15.4	15.4	15.1	*15.0*	*15.0*	15.5	15.4	*15.2*	*15.0*	*14.9*
Other revenue	7.1	7.3	7.0	7.0	*6.7*	*6.6*	7.2	7.5	*7.1*	*7.3*	*7.2*
Tax burden	**37.3**	**37.7**	**37.8**	**37.3**	**37.1**	**37.2**	**37.6**	**38.0**	**39.7**	**38.5**	**38.1**
Total general government expenditure	***50.8***	***49.0***	***48.2***	***46.7***	***45.3***	***44.1***	***48.8***	***53.4***	***49.4***	***47.9***	***46.7***
Intermediate consumption	6.9	6.9	6.2	6.0	*5.6*	*5.3*	6.9	6.8	*6.7*	*6.5*	*6.3*
Compensation of employees	12.8	12.6	12.1	11.5	*11.3*	*11.1*	12.6	12.0	*11.8*	*11.5*	*11.1*
Social benefits	19.8	19.7	19.8	19.3	*18.7*	*18.3*	19.7	20.2	*20.0*	*19.6*	*19.0*
Gross capital formation	3.7	3.0	3.2	3.2	*3.1*	*3.1*	2.9	3.2	*4.1*	*3.7*	*3.6*
Subsidies, expenditure	1.3	1.3	1.6	1.3	*1.4*	*1.3*	1.3	1.3	*1.1*	*1.0*	*0.9*
Property income, payable	1.9	2.1	2.5	2.6	*2.5*	*2.5*	2.1	2.7	*2.9*	*2.8*	*3.0*
Other expenditure	4.3	3.4	2.8	2.7	*2.6*	*2.6*	3.2	7.2	*2.8*	*2.9*	*2.8*
Net lending/borrowing	***-6.4***	***-4.0***	***-3.5***	***-2.5***	***-1.5***	***-0.4***	***-4.0***	***-7.9***	***-2.6***	***-2.1***	***-1.4***

Source: SURS: Main aggregates of the general government, April 2013, Stability Programme (2012 Update), Stability Programme (2013 Update)

The fiscal consolidation effort planned in SP2013 is slower than in the previous Stability Programme, with the biggest divergence occurring in 2013, largely due to one-off expenditure. Despite the adoption of additional measures to cut the deficit, the pace of consolidation under the SP2013 is slower than planned in the SP2012, as a result of the deterioration in the economy and because some of the measures planned last year were insufficiently defined or are of temporary nature. The biggest difference is in 2013, when one-off measures to recapitalise banks in the amount of 3.7% of GDP, which had not been included in the previous Stability Programme, will raise the deficit to an estimated 7.9% of GDP. This is 5.4 percentage points higher than projected in last year's Stability Programme. Excluding the bank restructuring measures, the deficit would remain unchanged from the previous year (4.2% of GDP), in contrast to the SP2012 projections that it would be reduced by 1.0 percentage point in 2013. Reductions of 1 percentage point in 2014 and 2015 had also been forecast in last year's programme, when balance was to be achieved. Under this year's Stability Programme however, the deficit will narrow by 4.5 percentage points in 2014 with the discontinuation of the bank restructuring measure and 0.8 percentage points excluding bank restructuring costs. The deficit will thus be brought below 3% of GDP a year later than projected in the SP2012 and the medium-term target of a balanced position will be achieved two years later in 2017.

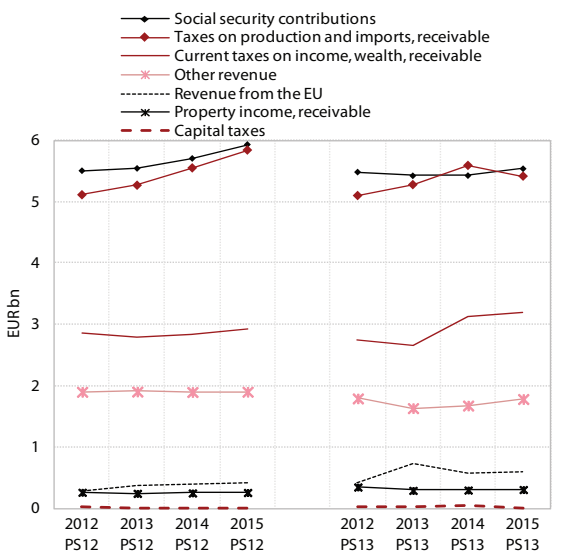
Figure 25: **Fiscal consolidation in the SP2012 and SP2013: change in expenditure, revenue and deficit from the previous year**



Sources: Stability Programme (2012 Update), Stability Programme (2013 Update).

Under this year's Stability Programme, the economic-policy mix in 2013 relies more heavily than the previous Stability Programme on raising revenue, with the slower pace of expenditure cuts the key reason for the higher deficit. The SP2012 did not include revenue-side measures that would significantly contribute to consolidation. Only minor changes were planned, but given the adverse macroeconomic environment they did not contribute to deficit reduction. Under last year's Stability Programme, growth in general government revenue would be less than GDP growth throughout the programming period, which would consequently reduce revenue as a share of GDP. By contrast, the SP2013 includes a significant consolidation effort on the revenue side at the start of the period, in particular in 2013 and 2014, when tax changes will raise general government revenue as a share of GDP by 0.7 percentage points in 2013 and an additional 1.3 percentage points in 2014. For 2014 and 2015 the SP2012 projected a nominal increase in revenue as a result of faster GDP growth,[66] whereas the revenue increase under this year's Stability Programme relies more heavily on discretionary measures. Given the decline in economic activity, the tax burden will increase to 38% of GDP this year and remain at this level until the end of the programming period (under last year's projections it would be 37.2% of GDP in 2015). The dynamics and size of the expenditure cuts are also different from last year. A nominal reduction in expenditure (excluding one-off expenditure) will

Figure 26: **General government revenue under the SP2012 and SP2013**



Sources: Stability Programme (2012 Update), Stability Programme (2013 Update).

[66] The EI 2012 assessed the VAT revenue projections as quite optimistic (Chapter 9.2.2).

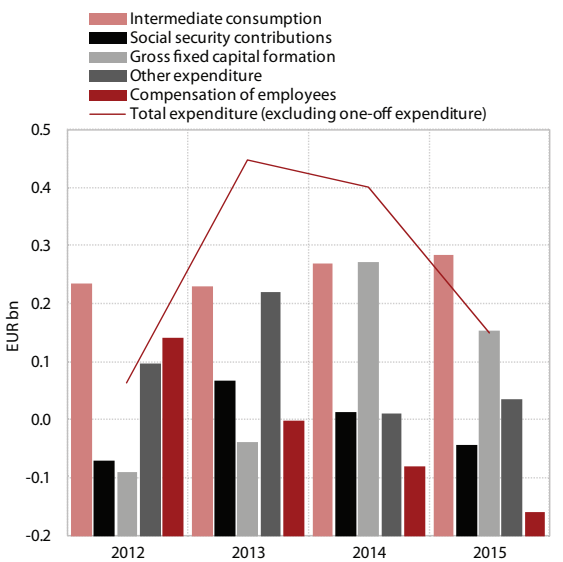
not occur this year or in 2014, and even in 2015 it will be less pronounced, resulting in the overall reduction in expenditure over the programming period being lower than forecast last year. Expenditure will thus decline by just 0.9 percentage points between 2012 and 2015, compared with 4.1 percentage points under last year's projections. By the end of the programming period expenditure will thus decline to 46.7% of GDP, a level that was to be achieved in 2013 under the SP2012.

The higher expenditure than projected last year, a key reason for the slower pace of deficit reduction over the entire programming period, is the consequence of the deterioration in the economy and a greater impact from automatic stabilisers, higher interest expenditure, and, beyond 2014, higher expenditure on investments. The expenditure in this year's projections is higher than planned last year, but much like last year a certain portion of the implementing measures are not sufficiently defined, rendering a direct benchmarking of this year's and last year's projections impossible. To a certain extent it is possible to estimate that faster expenditure growth is being driven by a deterioration in the economy, higher borrowing costs and one-off factors. According to the SP2013 projections, the expenditure level in 2013 is significantly higher as a result of EUR 1.32 bn in bank recapitalisation costs. Consequently, last year's target of a nominal reduction in expenditure this year will not be achieved. Even excluding one-off factors, expenditure in 2013 is well above last year's projections, by about EUR 450 m. While expenditure on interest and social transfers is higher than projected last year (largely as a result of transfers to the unemployed, other transfers to individuals and subsidies for student meals and transportation), intermediate government consumption is also higher. Compensation of employees remains at the level of last year's projections in nominal terms and gross fixed capital formation is slightly lower. Beyond 2013, this year's Stability Programme retains last year's guidelines on restrictive wage policy in the public sector and a restrictive policy on all types of transfers. Given the deterioration in households' financial position, it is sensible to re-examine the appropriateness of the system of social transfers, and to rectify solutions that are not in line with the underlying purpose of the changes and that have worsened the position of the most vulnerable recipients (see Development Report 2013, Chapter 4.2). In 2014 and 2015 expenditure is higher than forecast in the SP2012 largely as a result of higher investments (a significant increase in 2014) and intermediate government consumption expenditure. Even though increasing investment can have a positive impact on economic growth, the forecast sharp increase in 2014, when the target of

bringing the deficit below 3% of GDP is supposed to be achieved, is questionable and indeed associated with significant downside risk of additional cuts. It is therefore vital to design high-quality projects in order to secure the planned amount of EU co-financing and to strengthen public-private partnerships. As for intermediate consumption expenditure, there is a possibility of some funding being redistributed from the goods and services account to the wage bill account (up to 2% of the budget for wages), which is made possible by amendments to the budget implementation act for 2013 and 2014 (adopted in May 2013). Under the 2013 projections employee compensation remains unchanged in nominal terms throughout the programming period, and is already below last year's projections. A reduction in labour costs is a sensible measure in the consolidation process, but the prevailing approach in recent years – based largely on linear or progressive cuts and restrictions of bonuses – does not create an incentivising environment for employees. The formulation of more permanent employment solutions and a more incentivising wage policy in the public sector therefore remains a challenge, one that could contribute to greater efficiency and effectiveness.

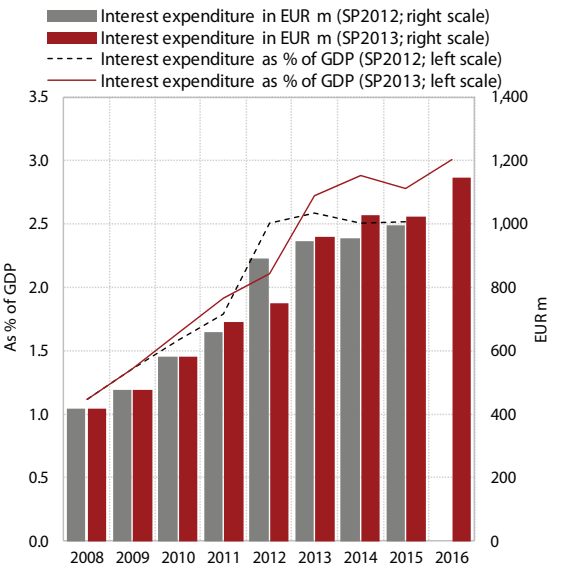
Throughout the period interest expenditure is also expected to exceed previous projections, swelling to 3% of GDP by 2016. This will further accelerate the crowding out of other expenditure, and has an adverse impact on the breakdown of expenditure. The

Figure 27: **Difference in selected expenditure categories in the SP2012 and SP2013**



Sources: Stability Programme (2012 Update), Stability Programme (2013 Update).
Note: The figure shows expenditure categories where the differences are largest and a comparison is sensible. Comparison of interest expenditure is shown separately in Figure 28.

Figure 28: **Interest expenditure in the SP2012 and SP2013**

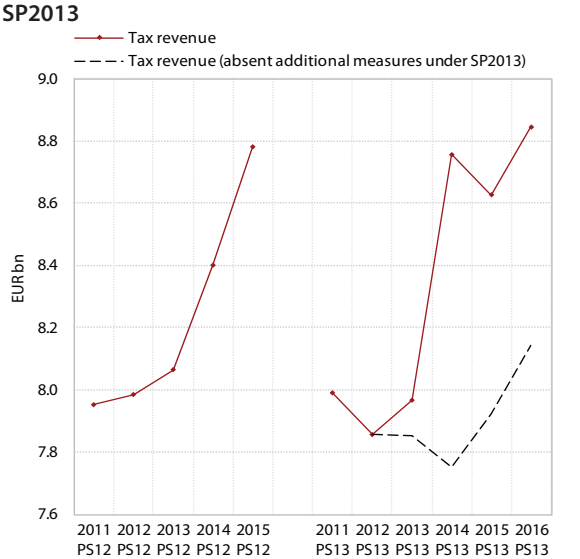


Sources: Stability Programme (2012 Update), Stability Programme (2013 Update).

increase in interest expenditure between 2011 and 2016 will thus exceed EUR 560 m, far outweighing the cuts in compensation of employees and expenditure on goods and services over the same period (EUR 512 m). There is an additional downside risk of interest expenditure even exceeding the projections, as it is projected to decline in nominal terms in 2015, which will be difficult to achieve given the projected change in general government debt.

Revenue projections in the SP2013 are lower this year given the weak economy, despite additional

Figure 29: **Tax revenue projections in the SP2012 and SP2013**



Source: Stability Programme (2012 Update), Stability Programme (2013 Update).

Box 5: **Estimate of planned subsidies in the 2013 update to the Stability Programme**

The decline in subsidies as a share of GDP projected in the SP2013 is in line with the theoretical and empirical findings on the impact of subsidies on economic growth, and mirrors the subsidy trends in the EU. Since theoretical and empirical analyses show that subsidies are effective in promoting economic growth[67] only in rare instances, their gradual reduction in the SP2013 is appropriate. The state budgets for 2013 and 2014, in which they are set slightly higher, had already targeted the earmarks more towards technological development and for job creation in private companies. Nevertheless a more favourable distribution of subsidies alone will not be enough to ensure effectiveness, as analysis by Burger et al (2012) shows that the current effectiveness even of subsidies for technological development and employment has been low in Slovenia due to an inappropriate disbursement system (recipients, amount of allocated funds, monitoring of use of the funds and their effects). The reduction in subsidies is also in line with trends in the EU. The subsidies projected in the SP2013 are at the level of the EU average as a share of GDP in 2013, with their share declining slightly below the average in 2014-2016. Nevertheless, in 2011 over a third of all EU countries had even lower subsidies. After increasing as a result of stimulus measures in 2009–2010 (2005–2008: 1.1% of GDP; 2009–2010: 1.3% of GDP), subsidies in the EU have been falling since 2011, and the decline in Slovenia is in line with these trends.

A comparison of the subsidy forecasts in the SP2012 and SP2013 is not reasonable, as the benchmark year (2011) in the 2012 update does not account for the change of status of Slovenian Railways, which no longer reports payments as subsidies. Factoring in these status changes, the planned reduction in subsidies in 2012 and 2013 was much larger under the SP2012 than in this year's update. The guidelines of this programme were subsequently not taken into account in the budgeting for 2013 and subsidies at the central (state) level alone rose by EUR 42 m or 0.12% of GDP over the previous year.

Table 21: **Subsidies under the SP2012 and SP2013, as % of GDP**

	2011	2012	2013	2014	2015	2016
General government subsidies (SURS)	1.3	1.3				
Subsidies (SP2012)	1.9	1.6	1.3	1.4	1.5	
Subsidies (SP2013)		1.3	1.3	1.1	1.0	0.9
Difference		-0.3	0.0	-0.3	-0.5	

Sources: SURS: Main aggregates of the general government sector, April 2013, Stability Programme (2012 Update), Stability Programme (2013 Update).

Even though subsidies will gradually decline, state aid is projected to surge, in 2013 and 2014 in particular. The key objectives laid out in the National Reform Programme 2013–2014 include restructuring of the banking sector via recapitalisation and the transfer of non-performing assets to the BAMC, coupled with corporate deleveraging and restructuring. The implementation of these measures via various instruments entails a significant risk of the direct or indirect granting of state aid via bank recapitalisation, the transfer of non-performing assets to the BAMC and privatisation. A very selective approach will also be needed in the planned corporate deleveraging and restructuring in view of empirical analysis showing that restructuring aid is typically high, and effectiveness as measured by the corporate survival rate is relatively low (for the EU, see for example London Economics, 2004; Nitsche and Heidhues, 2006; for Slovenia, see Rojec et al, 2008). Given the severe constraints on financing, it is only sensible to restructure financially distressed companies that are achieving higher value added per employee compared with other companies in industry.

[67] In particular subsidies which have a spill-over effect on the broader economy and society (research and development, training), promote entrepreneurship, in particular in young industries, and subsidies for employment for businesses in areas where unemployment is high, which generates better impacts than social transfers to the unemployed.

Box 6: **Impact of selected fiscal consolidation measures on economic growth and inflation**

Given all the tax increases, the decline in private consumption is, as expected, the strongest factor in the contraction in GDP; its impact is largest in the first year and stronger when it comes to permanent measures. Simulations of the impacts of various combinations of fiscal consolidation policies on economic growth show that tax increases alone do not achieve the objective of deficit reduction; they need to be coupled with other measures. Temporary tax measures have a smaller negative impact on economic growth than permanent measures, which also applies to the key measures in the SP2013. The results of simulations of these measures are expected in that they show that under all increases in the tax burden the decline in private consumption is the strongest channel of GDP contraction. A permanent rise in VAT that assumes revenue rising by 1 percentage point of GDP (corresponding to a 2 percentage point increase in the standard VAT rate) has a multiplier effect of -0.26; in the case of the proposed tax changes, the multiplier is therefore slightly larger (more negative) than -0.26. The VAT rise will thus reduce GDP by about 0.2 to 0.3 percentage points assuming an incomplete pass-through of the higher taxes into prices; the impact on private consumption may be smaller, but in that case part of the negative impact would be transferred to companies through higher costs. The permanent introduction of a real estate tax also affects all households; assuming the projected revenue, the multiplier peaks in the first year at -0.29. Considering the concurrent increase in the tax burden on households, there is a high probability that the negative impact on economic growth will exceed the sum of the individual measures. The impact will be additionally augmented by the potential introduction of a progressive crisis tax on personal income, where the impact on GDP growth in the first year of implementation is estimated at -0.08. The effects of these measures on economic recovery are positive in the long run, but fiscal consolidation is a precondition for the achievement thereof. Non-consolidation produces the biggest negative impact on economic activity (see Box 1). Should a lack of consolidation freeze Slovenia out of international financial markets, the negative impact of increased capital costs on GDP would be more permanent and would significantly outweigh any combination of consolidation measures, which would also have a stronger negative impact on GDP growth.[68].

The proposed revenue-side measures will also result in higher consumer prices, but the effect will depend on the actual pass-through into retail prices. The rise in the two VAT rates will have the largest impact, but the actual impact on inflation will depend on the pass-through of higher tax rates into retail prices. In the event of a complete pass-through and assuming unchanged inflation, annual inflation will be 1.2 percentage points higher; assuming a lower pass-through rate, which is likely given the weak economy and consecutive years of declining disposable income, the contribution will be proportionately lower, for example totalling 0.6 percentage points in the event half the tax increase passes through into prices. The impact of the introduction of the tax on sweet drinks will be significantly lower, contributing about 0.1 percentage points to inflation in 2013 assuming no change in consumption.

[68] The models are calibrated for normal circumstances and simulate economic activity in "normal" times. In the current situation in the euro area, Slovenia especially, the conditions are very weak and interest rates can increase even more than in stable conditions.

Tabela 22: **Comparison of general government debt and interest expenditure in the SP2012 and SP2013, as % of GDP**

	Realisaiion		Forecasts								
			SP - Update 2012 (April 2012)				SP – Update 2013 (May 2013)				
	2011	2012	2012	2013	2014	2015	2012	2013	2014	2015	2016
General government debt	***46.9***	***54.1***	***51.9***	***53.1***	***52.6***	***50.9***	***54.1***	***61.8***	***63.2***	***63.2***	***61.8***
Interest expenditure	1.9	2.1	2.5	2.6	2.5	*2.5*	2.1	2.7	*2.9*	*2.8*	*3.0*

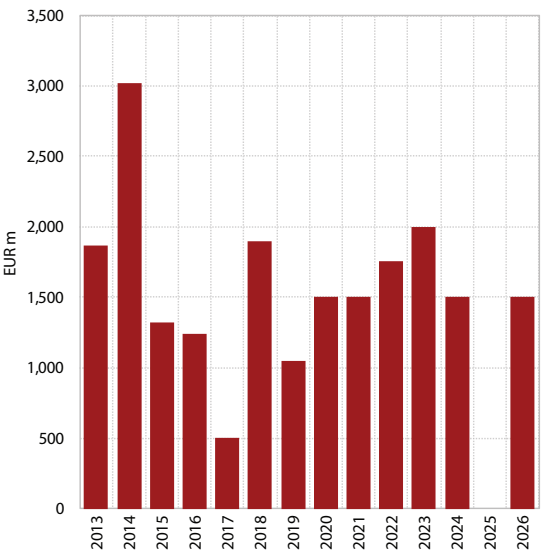
Sources: SURS: Main aggregates of the general government sector, April 2013, Stability Programme (2012 Update), Stability Programme (2013 Update).
Note: the projections in the Stability Programme (2013 Update) do not factor in the effects of bank restructuring via the BAMC in the amount of up to EUR 4 bn.

discretionary measures, but next year they are closer to the level projected in last year's Stability Programme. For this year almost all revenue categories are forecast lower in the SP2013 than in last year's document, despite additional revenue-side measures, making for total revenue cuts of EUR 84 m. Compared with last year's projections, revenue from personal income tax, social contributions and corporate income tax in particular are projected to be lower; VAT revenue would be EUR 200 m lower than forecast last year in the absence of the VAT rate rise in July. In view of the planned discretionary measures, nominal revenue projections for 2014 are roughly in line with last year's Stability Programme, but revenue could be lower if there is a stronger reaction from consumers to higher tax rates. Given the adopted changes in VAT and real estate tax, the breakdown of taxes will also be slightly different, with the tax burden on consumption and property increasing. EU funding under the SP2013 is also slightly higher than projected last year.

In terms of reducing the structural deficit, this year's Stability Programme is less ambitious than last year's document. Based on the projections and calculations of the output gap in the SP2013, this year's reduction in the structural deficit will be smaller than projected last year. Assuming a slightly narrower output gap as indicated by IMAD calculations (see Chapter 2.1), the structural deficit will in fact even widen slightly this year.

The general government debt has been growing faster than was projected last year, with the added downside risk that it will exceed the SP2013 projections at the end of the programming period. The general government debt in this year's Stability Programme is higher than projected last year. It was already wider in 2012 as a result of the issue of a bond for pre-financing in 2013, is growing faster this year (even excluding the effects of the issue of government-guaranteed BAMC bonds), and is projected to widen in the years ahead. The trend is associated in particular with a higher primary deficit and the faster escalation in interest expenditure, while the payment of principal is also high, especially next year. Although the level of debt at the end of the programming period could still be below the current EU average, its widening over the period will be significantly faster, which could have a crucial effect on investor mood and could additionally narrow the fiscal policy manoeuvring room in subsequent years. The actual debt increase could be even higher in the event of the projected disposal of assets acquired by the BAMC or the privatisations not being fully realised or not realised at all, or in the event of a large-scale calling of government guarantees (see Chapter 4). Successful implementation of measures to strengthen bank stability is therefore crucial to investor mood, and to ratings by the international agencies. Transparent and fast execution in line with the time frame determined by the SP2013 is crucial, which will also reduce the pressure on the growth of government debt.

Figure 30: **Payment of principal on government debt**



Source: Ministry of Finance.
Note: (as at 23 May, 2013).

8. Fiscal policy challenges

Fiscal consolidation is a key challenge for economic policies, in particular since deficit reduction in a weak economy demands additional measures that significantly impact the entire economy. A weak economy, severely restricted access to financial markets and the meeting of commitments at EU level require a continuation of the fiscal consolidation started in 2012. In addition to the restructuring of the banking system and corporate deleveraging, this is the key economic-policy challenge, which will improve the stability of the macroeconomic environment for Slovenian business as the necessary baseline for a return to growth and development. After a significant reduction in the general government debt last year, the fiscal consolidation forecast in the SP2013 is slower than projected in the previous programme. The biggest difference is forecast for 2013, largely as a result of the one-off expenditure associated with bank recapitalisation and the restructuring of the banking system. However, even excluding these specific transactions, the general government deficit will be roughly at the level on the previous year, a departure from the fiscal policy targets adopted last year. Higher interest expenditure and expenditure on social benefits is coupled by significantly higher intermediate government expenditure. Despite additional measures to limit compensation of employees in the general government sector and significantly lower expenditure on investments and subsidies this year, the nominal reduction in expenditure forecast last year will not be achieved, not least because it was not underpinned by specific measures. Moreover, revenue projections for this year are also lower given the weak economy, despite additional discretionary measures that will take effect in the middle of the year. Consolidation will also be slower than planned in subsequent years, due in large part to higher interest expenditure and higher-than-planned investments.

In this year's Stability Programme higher taxation is a key component of consolidation, but that is sensible only as an auxiliary measure in an economic policy mix where structural measures to sustainably reduce expenditure must play the central role. Measures to reduce the deficit directly impact economic activity, but the effects of non-consolidation on the economy would be significantly more negative even in the short term, as borrowing costs would surge and Slovenia would very likely be completely shut off from the financial markets. The consolidation process, therefore, requires an economic policy mix whose impact on economic growth is less damaging, while providing for a sustainable reduction of the deficit. This year's Stability Programme places much greater emphasis on revenue-side measures, which primarily increase the burden on consumption and can raise corporate costs if they do not entirely pass through into prices. But this entails the risk of revenue falling short of projections as consumers might change their behaviour given the weak economy; the projected revenue from a real estate tax is also relatively high and will affect disposable income and household spending. Although the higher tax burden in indirect taxes will contribute to fiscal consolidation, it is sensible only as an auxiliary measure in an economic policy mix where measures to reduce expenditure must play the central role. It is important that curbing growth in or even reducing expenditure be achieved via structural changes, and only to a lesser extent via a contraction in investment activity and emergency measures that are not viable in the long term.

The SP2013 does not provide a comprehensive response to this challenge, which will require measures to be framed this year and in the coming years that have a sustainable impact and do not cause new imbalances. The discretionary expenditure-side measures specified in the SP2013, some of which are temporary, are focused on limiting compensation of employees and social transfers. A reduction in labour costs is a sensible measure in the consolidation process, but the prevailing approach in recent years – based largely on linear or progressive cuts and restrictions of bonuses – does not create an incentivising environment for employees. The formulation of more permanent employment solutions and a more incentivising wage policy in the public sector therefore remains a challenge, one that could contribute to greater efficiency and effectiveness. In social transfers it is urgent to correct decisions adopted last year that do not pursue the main objective of the changes: to provide a more target-based approach, and to improve the transparency and efficiency of the system (see also Development Report 2013, Chapter 4). In the short term the key challenge of economic policy will be to put in place permanent expenditure-side measures that will prevent the introduction of a crisis tax in 2014. The crisis tax would swing the deficit-reduction policy mix strongly to the revenue side. Not only is this a marked departure from the stated goals, it is also questionable what their actual impact would be given the weak economy and the strong contraction in private consumption expenditure. After the latest measures the scope to raise taxes is severely limited, though there is still room for changes, as stated in the SP2013, in improving the collection of existing duties and in measures to curb the grey economy. Investment is set to rise next year according to projections, which in principle has a positive impact on economic growth. Nevertheless, the forecast sharp increase in 2014, when the target of

bringing the deficit below 3% of GDP is supposed to be achieved, is questionable and is indeed associated with significant downside risk of additional cuts, in particular given that this is a flexible part of the budget where it is easiest to make cuts since that does not require legislative changes. Considering the significant decline in investments in recent years and their potential to drive economic growth, investment cuts would additionally undermine economic activity. It is therefore vital to design high-quality projects in order to secure the planned amount of EU co-financing and to strengthen public-private partnerships. The planned cut in subsidies, which are more targeted at technological development and job creation in private companies, is reasonable, but a more favourable distribution alone will not lead to greater efficiency. More far-reaching structural measures are therefore needed on the expenditure side, and they have to include continued streamlining of the public sector with structural measures aimed at increasing efficiency. Expenditure restructuring must be targeted at strengthening the role of development expenditure for the promotion of competitiveness and ensuring the long-term sustainability of social protection system, which is particularly important in the years when rising interest expenditure will crowd out the more flexible types of expenditure in the consolidation process. In the absence of serious structural adjustments, a further linear cutting of certain expenditure could lead to a deterioration in the quality of public services in just a few years (in particular in education, research and health care). It therefore makes sense to consider shifting some services currently provided by the public sector to the private sector.

Fiscal consolidation faces the additional challenge of a sensible implementation of the balanced-budget fiscal rule. By amending Article 148 of the Constitution in May 2013, Slovenia fulfilled the requirement of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union regarding the transposition of a balanced budget rule into the constitution or a legislative document with equal force. The balanced budget rule will be detailed in an implementing act, and is meant to ensure a balanced budget, defined as a structural balance of up to 0.5% of GDP, by 2015, except in extraordinary circumstances. Given the latest simulations of the fiscal rule, which do not envisage the occurrence of extraordinary circumstances, this will require an additional fiscal effort in the next two years.

Considering the rapid increase in the general government debt this year and in the previous years, partly as a result of the recapitalisation of banks and government-owned companies, fiscal consolidation coupled with a successful restructuring of the banking system is the key to keeping the debt at a sustainable level. The general government debt and debt servicing costs have been rising, which has resulted in interest expenditure increasingly crowding out other expenditure and creating a negative feedback loop. In addition to this expenditure and the financing of the primary balance, which will be balanced after 2014 according to Stability Programme projections, the one-off rise in debt this year will be the result of measures to restructure the banking system, which is vital to creating a more stable macroeconomic environment, kick-starting growth and improving Slovenia's standing on the financial markets (see Impact of the Financial Crisis on the Credit Market in Slovenia, Economic Issues 2013). The planned government guarantees for the bond issue by the BAMC will increase debt by 11.4% of GDP, but the effect will be mitigated in subsequent years as the transferred assets are sold off and liquidated. Yet even in the event of the entire project being successfully completed, the general government debt would rise to above 60% of GDP at the end of the programming period, and given lower proceeds from the sale of the assets transferred to the BAMC, it would approach 70% of GDP. Other downside risks to faster debt growth remain high. Given the widening differences between the more and less vulnerable euro area countries, bond yields to maturity may rise in a spill-over effect throughout the euro area that will affect Slovenia's borrowing costs. If the financial markets start doubting Slovenia's commitment to consolidation measures and bank restructuring, securing the requisite funds to finance the deficit and roll over debt would be rendered difficult or even impossible, casting doubt on the execution of other measures set out in this year's Stability Programme. Limited government access to financing would also affect the borrowing conditions of the private sector, which would have a further adverse impact on competitiveness and potential growth.

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II.
Labour market developments and reforms during the crisis

Summary

The situation on the labour market in the EU and Slovenia continues to be affected by the economic crisis. The decline in economic activity has triggered a process of labour market adjustment to lower activity. In the EU as a whole, the employment rate of the population (aged 20-64 years) in 2012 was 1.8 percentage points lower than in 2008, while the unemployment rate in 2012 totalled 10.4%, 3.4 percentage points more when compared to 2008. In Slovenia, the employment rate (20-64 age group) fell to 68.3%, which is 4.7 percentage points less than in 2008, while the unemployment rate doubled and amounted to 8.9% in 2012.[1] Greater deterioration of the labour market situation in Slovenia when compared to that in the EU is due to, among other reasons, a significant decline in economic activity as a result of structural weaknesses in the Slovenian economy, and partly to the impact caused by the substantial increase in the minimum wage on the fall in competitiveness during the crisis in Slovenia. With the crisis persisting, structural problems on the labour market continue to have more of an impact. In 2012, the long-term unemployment rate rose to 4.6% in the EU as a whole, which is 2 percentage points more than in 2008. In Slovenia, long-term unemployment rose even faster and more than doubled in 2008–2012.

Countries responded to the worsening situation on the labour market by strengthening active labour market measures and introducing labour market reforms. In 2009, all countries increased the level of funding for labour market policy measures, while in 2010 and 2011 some of the countries, under the influence of fiscal consolidation, reduced these expenses despite a further worsening of the labour market situation. The majority of countries strengthened their educational and training programmes during the crisis, while several countries increased access to unemployment benefits at the beginning of the crisis. Since the ability to adjust to the labour market, which is significantly influenced by labour market institutions, became vital during this crisis, numerous countries began to implement labour market reforms. During the crisis period, reforms of active employment policy were most frequent, while a significant rise was also seen in the number of reforms in the area of employment protection and unemployment insurance.

Slovenia responded to the deteriorating situation on the labour market by adopting interventional acts aimed at preserving jobs and enhancing the implementation of active employment policy programmes, but over time the policy became more passive. In 2009, two interventional acts were adopted, aiming to preserve jobs, thus temporarily alleviating the drop in employment in Slovenia. The number of unemployed persons that participated in active labour policy programmes increased significantly in 2009 and 2010. After 2010, as unemployment continued to increase and the unemployment benefits system became slightly more favourable for the unemployed, the volume of passive financial support, in particular, began to rise. In 2011 and 2012, the participation of the long-term unemployed, older persons and low-skilled unemployed in active employment policy programmes dropped sharply. A decline was also seen in the participation of the unemployed in training and educational programmes, which, in view of the growing imbalances on the labour market, is considered to be an inappropriate policy. Slovenia falls within a group of countries which allocate a relatively low level of funds for labour market policy (measured in % of GDP), however, the volume of this passive support is rising. Given the growing number of structural problems on the labour market, it would be highly recommended to strengthen the implementation of active employment policy programmes, particularly those that are targeted at the needs of employers, and to increase the efficiency of active employment policy programmes.

Since the beginning of the crisis, Slovenia has amended the system of unemployment insurance on a number of occasions and in 2013 it also enforced amendments in the area of employment protection. However, these amendments were not introduced early enough. With the adoption of the Labour Market Regulation Act in 2010, Slovenia slightly improved (by change in eligibility criteria) access to, and increased the level of, unemployment benefits. The Act, improving the income security of the unemployed, came into force in 2011 when the policy in other countries was no longer aimed at enhancing the income security of the unemployed, but already at reforms that increased work incentives. Greater income security for the unemployed in Slovenia was in force for a relatively short period of time, as already in mid-2012 the level of benefits was reduced due to public finance consolidation. Changes to employment protection were adopted only in April 2013 with the Act Amending the Employment Relationships Act. Amendments to the labour legislation were aimed at increasing flexibility, since they lowered the costs for the dismissal of some categories of workers and simplified the dismissal procedure. Even though they did not involve any radical changes, they led to a decline in the employment protection legislation (EPL) index

[1] The source of the indicated data is Eurostat and is based on the labour force survey.

(developed by the OECD for the purpose of comparing international labour market regulations) below the OECD average; this points to the fact that the labour legislation in Slovenia can no longer be considered rigid, as it once was. As the objective of the amendments was to reduce segmentation on the labour market, other amendments, which the EPL index does not include, were also adopted, which might act towards reducing flexibility (e.g. the introduction of severance payments for fixed-term employments and the introduction of quotas in employing agency workers on fixed-term contracts). The adopted amendments are thus a consequence of pursuing two different primary objectives (increasing the flexibility and reducing the segmentation) and compromises in the negotiations with social partners. Nevertheless, the amendments were indeed a step in the right direction, since the econometric estimates of the effects of the adopted amendments reveal positive, yet modest, effects on employment. However, Slovenia was slow to move with the amendments aiming to achieve greater flexibility of contractual relationships because in 2010, when the amendments concerning the determination of the minimum wage and the Labour Market Regulation Act were adopted, it missed the opportunity to formulate a comprehensive reform.

Following the decline in economic activity, the adjustment to the changed conditions was less pronounced in wages than in employment. The modest adjustment of wages was largely due to a rise in the minimum wage, as well as to the wage formation mechanism (mostly at the sectoral level). In addition to one of the largest drops in economic activity in the EU during the crisis, Slovenia recorded the greatest increase in the minimum wage, raising it by almost 30% in real terms in the period 2008–2012. Various studies[2] indicate that the decisive factor in the system of wage formation (and hence the movement of wages) in Slovenia is that wages are determined by collective agreements at the level of sectors, which might reduce the responsiveness of wages to changed economic circumstances. The austerity measures of the public sector wage policy, which during the crisis, in addition to freezing or cutting the basic wages of civil servants, also abolished most of the elements designed to stimulate wages, have led to increasingly smaller differences between wages, which has a fairly negative effect on the motivation of employees.

The main challenges of the economic policy are increasing the scope of labour activity and enhancing the ability to adapt to the changed economic circumstances. Due to the notable deterioration on the labour market and significant structural imbalances, the Slovenian objective (EU 2020) to achieve a 75% employment rate by 2020 (of the population aged 20-64) has become unattainable, since the number of employed persons fell significantly during the 2008–2012 period. To reverse this trend and to gradually achieve the set objective, Slovenia should develop, as soon as possible, a set of measures aimed at increasing the scope of labour activity and ensuring greater coherence of individual policies that go beyond labour market policies. In addition to further structural reforms, efforts should concentrate on public finance consolidation, efficient rehabilitation of the banking system and the creation of an environment that fosters entrepreneurship (for details see the Development Report 2013). The changes that were brought about this year to the labour market regulation were a step in the right direction, however, it is necessary to monitor the effects of changes that were already made regarding the labour market regulation, their corrections and further reforms of labour market institutions, whereby particular emphasis should be placed on enhancing the efficiency of active employment policy programmes and the functioning of the employment service. Because student work is one of the main reasons for the strong segmentation of the labour market in Slovenia, a different arrangement for student work is another challenge to be met. Such a challenge also includes enhancing the ability to adapt to the changed economic circumstances, not only by achieving a more flexible regulation of the employer-employee relationship, but also by strengthening the role of active employment policy programmes and by a wage setting system that would allow a more timely response to changes in economic activity, mostly by means of collective agreements negotiated at company level. Also, it would be worth examining the system for determining the minimum wage. Formulating measures in the field of wages and changes to the wage system in the public sector would offer more incentives and would not lead to a levelling of wages is another challenge amid continued fiscal consolidation.

[2] Analyses and surveys in the framework of the Wage dynamic network project.

Introduction

The EU labour market is still adjusting to the circumstances brought about by the economic crisis. The decline in economic activity has triggered a process of adjustment of the EU labour market to a lower level of activity. When the crisis began, the decline in employment was relatively modest when compared to the decline in economic activity, as in the majority of states the first response to the crisis was shortening work hours. For this reason, and also due to the usual delay in the effects of lower economic activity on the labour market, labour hoarding and a subsequent decline in employment took place in the time when the economy was already slightly recovering. Employment adjustment still continues, since in 2012 (when another reduction was recorded), the level of economic activity in the EU on average still lagged behind the level from 2008. In the EU as a whole, employment was on average 2.6% lower in 2012 than in 2008. Contrary to this, the unemployment rate in the EU was on average 3.4 percentage points higher in 2012 over 2008 (totalling 10.4%). The adjustment of wages, however, was relatively modest (ECB, 2012).

Labour market adjustment is influenced by labour market institutions where an intensive process of reforms is taking place. Among labour market institutions, the ones most frequently emphasised are: the importance of employment protection or different forms of flexibility, the measures of active labour market policy, unemployment insurance and the wage bargaining system. Lesche, J. and Watt, A. (2010) note that labour market performance (at least at the onset of the crisis) has generally been best in those EU countries that are characterized by high internal workplace flexibility and well-developed and responsive institutions and government On the other hand, the combination of high external flexibility[3] with weak labour market institutions and strong dualism produced poor outcome for workers and led to a significant rise in unemployment. ECB experts note that multi-year collective agreements which determine wages, were an important reason for the delay in wage adjustment at the beginning of the crisis. This led to the fact that, in some countries where measures aimed at achieving fiscal consolidation were adopted, wages in the public sector responded to the crisis more quickly than in the private sector (ECB, 2012). Several studies show that employment adaptation is much more pronounced in countries with a less regulated labour market or with weaker employment protection (e.g. the USA and Great Britain) than in central Europe (e.g. Germany and France). Given the poor prospects for economic recovery, considerable macroeconomic imbalances and growing problems on the labour market, reforms became a necessity. The European Commission estimates that this was the reason underlying the strengthening of the reform process on the labour market in the EU during the crisis. In the framework of the European semester, numerous states received recommendations in relation to amendments in the field of employment protection, wage bargaining, labour taxation, active labour market policy, early retirement, pension systems and education.

This section presents the labour market developments during the crisis and the response of the labour market policy in the EU and Slovenia. The first chapter outlines the labour market developments in the EU and Slovenia. The second chapter presents the active labour market policy in the EU. Furthermore, we also provide an analysis of the active employment policy in Slovenia, which is intended to contribute to reducing labour market mismatch, facilitating transitions from school to work, and improving the employability of unemployed and employed persons. In the third chapter, we focus on labour market reforms, highlighting the reforms of unemployment benefits and changes in employment protection implemented in EU Member States over the last four years. Furthermore, we present changes in employment protection in Slovenia in more detail, which reflect the European Commission's recommendation on bridging the gap between the rights and responsibilities arising from temporary and permanent employment contracts. We also provide an assessment of changes in labour market regulation which have been adopted this year, and conclude by presenting the challenges faced.

[3] The term external flexibility denotes relatively modest employment protection, which allows a rapid adjustment of labour.

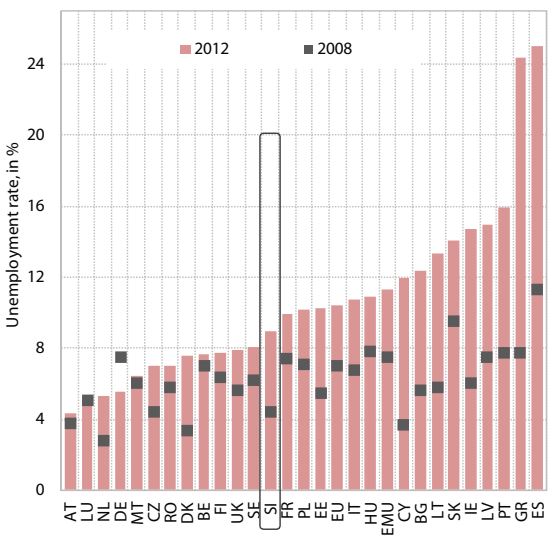
1. Changes in the labour market situation in the period 2008-2012

1.1. Changes in the labour market situation in the EU

After 2008, the conditions on the labour market tightened notably due to the global economic crisis and the continuation of low economic activity. After the onset of the crisis in 2008, the first major adjustment to the labour market took place at the beginning of 2009, while throughout the year 3.9 million jobs (EMU 2.7 million) were lost in the EU. With economic activity declining, the majority of the Member States adopted measures aimed at temporarily alleviating the effects of the crisis on the labour market, which slowed down a worsening of the situation. In 2010, unemployment soared the most in countries which were most severely affected by the crisis and had rather little leeway to act at the state level (Greece), or which have a flexible labour market, allowing rapid adjustments (Ireland, the Baltic countries). In 2011, the labour market situation in the EU as a whole eased off slightly, since the number of persons in employment rose by 0.2%, while the unemployment rate remained at a similar level as the year before. In the EU, in 2012 the labour market situation again deteriorated. Due to a decline in economic activity, a further 1 million jobs were lost in the EU in 2012, a total of 5.8 million jobs (EMU 4.2 million) since 2008. In the EU, the unemployment rate, on average, totalled 10.4% in 2012, 3.4 percentage points more than in 2008. The gaps in unemployment rates among the Member States continued to grow further, reflecting different responses of labour markets to the crisis. In 2012, the employment rate (20-64 age group) totalled 68.5% in the EU as a whole, which is 1.8 percentage points less than in 2008. Due to lower adjustment costs, the drop in the number of persons in temporary employment was more pronounced than in the number of persons with permanent employment contracts. The gaps in unemployment rates between Member States widened considerably, reflecting the different effects of the crisis on individual countries and the differences in labour market adjustment to lower economic activity. In the majority of countries, the average number of actual hours worked per week in the entire period fell (schemes stimulating the shortening of working hours), resulting in a higher share of employment for shorter working hours (partial employment).

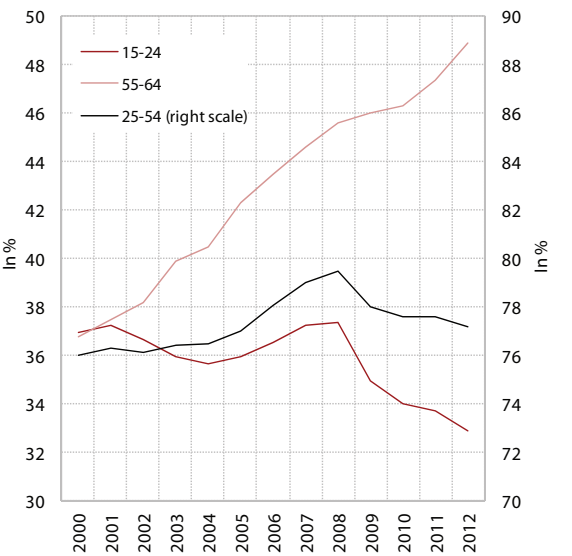
During 2008–2012, employment opportunities for men and the young worsened markedly. The employment rate for men decreased more than the employment rate for women. This was largely due to a decline in activity in sectors that mainly employ men with lower education (e.g. construction). The decline in activity in the entire period drastically reduced employment opportunities particularly of the young population, with the youth unemployment rate (aged 15-24) rising and reaching 22.8% in 2012 (EMU 23.0%), which is 7.2 percentage points more than in 2008. In Greece and Spain, the unemployment rate of the young exceeded 53% and in 2008-2012, it more than doubled in both countries. The problem of youth employment is generally more pronounced

Figure 1: **Unemployment rates in the EU in 2008 and 2012**



Source: Eurostat.

Figure 2: **Employment rates in the EU, by age group**



Vir: Eurostat.

among less-educated people, however, the declining employment rate of young people who have at least a secondary education reveals increasing problems in the transition from education to employment (EC, 2012b). Unlike in other age groups, the employment rate of older people (aged 55-64) climbed by 3.3 percentage points to reach 48.9%, which is a result of pension system reforms. However, differences between individual states remain significant.

In 2008-2012, the long-term unemployment rate rose, while a strong increase was also seen in the share of the long-term unemployed. Since the crisis began, the long-term unemployment rate rose in all EU countries, except in Germany, particularly in countries which were most affected by the crisis. In 2012, 4.6% (EMU 5.3%) of the active population was unemployed for more than 12 months; unemployment increased most markedly among young people and those with low education levels. The share of long-term unemployed in the total number of unemployed in the EU amounted to 44.4% in 2012, which is 7.5 percentage points more than in 2008. The increasing number of structural problems in a number of countries also shows in a rise in the very long-term unemployment rate,[4] amounting to 2.5% in 2012, which is 1 percentage point more than in 2008.

Due to the system of wage bargaining, a relatively modest response to the crisis was seen in wage movements. ECB experts note that the multi-year collective agreements which determine wages constituted an important reason for the delay in wage adjustment at the beginning of the crisis. This led to the fact that, due to fiscal consolidation, wages in the public sector in some countries responded to the crisis more quickly than in the private sector (ECB, 2012). According to the European Commission's assessments, wages in 2010 were still relatively unresponsive to the worsening of the labour market (EC, 2011). Only in 2011 was the movement in the nominal compensation per employee influenced by the need to lower unemployment, which increased substantially due to the labour market adjustment by reducing employment (EC, 2012a).

1.2. Changes in the labour market in Slovenia

Due to the economic crisis, employment in Slovenia declined in 2008-2012, particularly in the private sector. As a result of the fall in economic activity in 2009 and the consequent labour market adjustment to the lower level of economic activity in the following years, the number of persons in employment in Slovenia recorded a decrease. In 2012, their number (according to the statistical register) was around 69,000 persons or 8.0% lower compared to 2008. The number of people in employment was in decline only in the activities of the private sector where, in 2012, there were 78,000 or 11% fewer employed persons than in 2008, while in this period the largest decrease was seen in construction (by 32%). Public services, however, recorded an increase in the number of employed persons in 2008-2012, rising by 9,000 persons or 5.2%.

Figure 3: **Economic growth and employment**

Source: SORS; calculations by IMAD.

The decline in employment was larger in Slovenia than in the EU overall, which is a result of a larger decline in economic activity. Since the drop in economic activity in 2009, the employment rate is decreasing faster than on average in the EU. In the period from 2008, when it attained the highest level (68.6%), considerably exceeding the EU average, it dropped to 64.1% in 2012 and was thus slightly below the EU average. In Slovenia, the employment rate (15-64 age group) decreased by 4.5 percentage points in 2008-2012 (on average by 1.6 percentage points in the EU). Similarly, as in the EU, the contraction in employment was more severe for men than for women[5], mainly due to the sharp fall in the construction sector. Likewise, the unemployment rate in Slovenia witnessed a greater increase than in the EU as a whole.[6] Greater deterioration of the

[4] The term very long-term unemployment is used to refer to a person whose unemployment lasts for two or more years.

[5] Since 2008, when it totalled 72.7% and was equal to the European average, the number of employed men has dropped below the EU average, reaching 67.4% in 2012. In 2012, the employment rate for women totalled 60.5%, which is 4 percentage points less than in 2008.

[6] In Slovenia, the unemployment rate totalled 8.9% in 2012, 4.5

Table 1: **Employment rates in Slovenia and the EU, by age groups (in %)**

	Slovenia				EU27			
	15-24 years	25-54 years	55-64 years	15-64 years	15-24 years	25-54 years	55-64 years	15-64 years
2008	38.4	86.8	32.8	68.6	37.4	79.5	45.6	65.8
2009	35.3	84.8	35.6	67.5	35.0	78.0	46.0	64.5
2010	34.1	83.7	35	66.2	34.0	77.6	46.3	64.1
2011	31.5	83.1	31.2	64.4	33.7	77.6	47.4	64.3
2012	27.3	83.3	32.9	64.1	32.9	77.2	48.9	64.2

Source: Eurostat.

Table 2: **Unemployment rates in Slovenia and the EU, by age group (in %)**

	Slovenia				EU27			
	15-24 years	25-49 years	50-74 years	15-74 years	15-24 years	25-49 years	50-74 years	15-74 years
2008	10.4	3.8	3.3	4.4	15.6	6.3	5.0	7.0
2009	13.6	5.5	3.9	5.9	19.9	8.2	6.1	8.9
2010	14.7	7.3	4.4	7.3	20.9	8.9	6.6	9.6
2011	15.7	7.8	6.5	8.2	21.3	9.0	6.6	9.6
2012	20.6	8.5	6.3	8.9	22.8	9.9	7.1	10.4

Source: Eurostat.

labour market situation in Slovenia relative to the EU is linked to a significant fall in economic activity due to structural weaknesses of the Slovenian economy, but also to the impact of the significant increase in the minimum wage and the effects on the drop in competitiveness.

The deterioration of the labour market situation in Slovenia was also most notable among the young. As shown in Table 1, the youth employment rate (aged 15-24) dropped by 11.1 percentage points in 2008-2012. On the other hand, the youth unemployment rate almost doubled. The significant deterioration in the situation of young people on the labour market was a result of the following factors: (i) an increasing share of temporary employment among the young population (non-extension of employment contracts and cuts in the number of employees in companies); (ii) low labour demand or number of job vacancies, where young people often have fewer job opportunities due to a lack of work experience (iii) a reduction in the volume of student work which was more pronounced in the second half of 2012;[7] (iv) mismatch between the structure of tertiary graduates according to their fields of education and labour market demands, and a considerable increase in the number of graduates. With low demand and an increased number of the Bologna programme graduates entering the labour market in the period 2008-2012, the unemployment rate of persons with tertiary education almost doubled, thus amounting to 6.1% in 2012. The deterioration of job prospects for young people raises the probability and scope of brain drain and calls for the formulation of innovative and effective programmes and approaches for the implementation of employment guarantees for young people[8]

In 2008-2012, the employment rate among low-skilled people dropped markedly. The employment rate of low-skilled people, which in 2008 amounted to 42.9%, fell to 34.6% by 2012, which is largely due to a decline in the construction sector. A similar drop was observed in the employment rate of people with a secondary education. In 2008, it was above the EU average, totalling 72%, but dropped to 65.8% by 2012, thus falling below the EU average. The employment rate of people with a higher education fell from 87.5% in 2008 to 85.5% in 2011, recording an even greater drop in 2012, to 84.2%, which is still higher than in the EU overall (81.8%).

Slovenia has the lowest employment rate of older people, but it will increase in the years to come due to the adopted pension reform. The employment rate in the age group of 55-64 was 32.8% in 2008, climbing

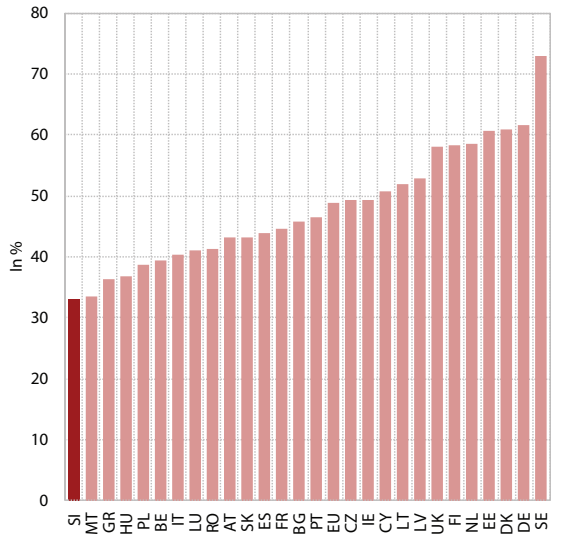
percentage points more than in 2008, while in the EU as a whole it rose from 7% in 2008 to 10.4% in 2012.

[7] We estimate that the reduction in the volume of student work was partly due to the rise in concession levies to 23%, which came into effect on 1 June 2012 with the Fiscal Balance Act.

[8] Young people became the first priority group in the European employment policy. In the framework of the Youth Guarantee scheme, the funding is intended for the formulation of programmes tackling youth unemployment.

to 35.0% by 2010 as a consequence of the structural demographic effect and the pension reform from 2000 (particularly for women). In 2011, the employment rate of older people witnessed a substantial decline (to 31.2%), while last year it recovered slightly (to 32.9%), but is still among the lowest in the EU. The reforms to the pension system adopted at the end of last year could, by extending the period of activity, raising the retirement age and making the retirement age for women the same as for men, increase the employment rate of older people in the years to come.

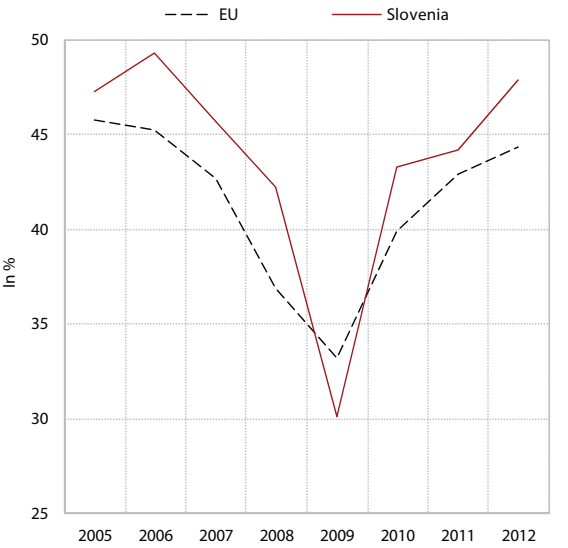
Figure 4: **Employment rates of older workers (aged 55-64) in the EU in 2012**



Source: Eurostat.

Structural unemployment has been rising ever since 2009 and almost half of the unemployed are long-term unemployed. The rising levels of long-term and very long-term unemployment are a sign of growing structural problems on the labour market. The long-term unemployment rate more than doubled in 2008-2012, amounting to 3.9% in 2012. Also the very long-term unemployment rate more than doubled in the 2008-2012 period, totalling 2.3% in 2012, and nearly caught up with the EU average. As seen in Figure 5, the share of long-term unemployed has continued to rise since 2009 and amounted to 47.9% in 2012 according to the labour force survey (17.8 percentage points more than in 2009). Long-term unemployment also reduces the possibilities to re-employ the unemployed and the possibilities to substantially reduce unemployment in the coming years. Research conducted by the OECD (2012) states that long-term unemployed persons have a 50% chance of leaving unemployment, while among the short-term unemployed, this chance is approximately 80%. This highlights the relevance of this problem so as to improve the situation on the labour market.

Figure 5: **Long-term unemployment to total unemployment in Slovenia and the EU, in %**



Source: Eurostat.

Wage growth in the private sector slowed gradually during the crisis, however, adjustment in response to the crisis was less pronounced in wages than in employment. The first response of the private sector to the crisis was reducing the volume of overtime work and shortening working hours, followed by a significant reduction in employment, and in 2009 by a slowdown in wage growth, which was more evident and faster in industry than in market service activities. During the past years, a considerable decrease was also seen in extraordinary payments, which reflect the successful performance of companies. Nevertheless, the significant improvement in wage growth in the private sector in 2010 and 2011, amid low economic activity, rising unemployment and relatively low inflation, was mainly a result of the increase in the minimum wage[9] and changes in employment structure due to layoffs of workers with relatively low wages.[10] In 2009-2012, wage growth in the private sector resulted only from the increase in the basic wage, while the contributions to growth arising from overtime and extraordinary payments were negative. Without increasing the minimum wage and changing the employment structure, the growth of

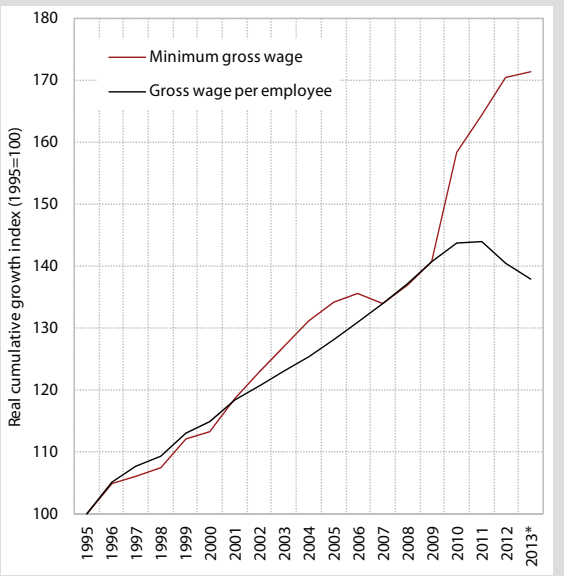
[9] According to our estimates, the gross wage increase in private sector activities in 2010 (5.1%) contributed around 3 percentage points In 2011-2012 the gradual increase in the minimum wage (estimated at less than 1 percentage point) had only a minor influence on the growth of the private sector's average wage.

[10] This was underpinned by layoffs of workers with relatively low wages which statistically increased the level of the average wage. According to our estimates, 0.9 percentage points of the average wage growth in the activities of the private sector in 2009 was a consequence of this effect; in the following two years, this share was 0.5 percentage points and 0.2 percentage points respectively.

Box 1: **Minimum wage in Slovenia during the crisis[1]**

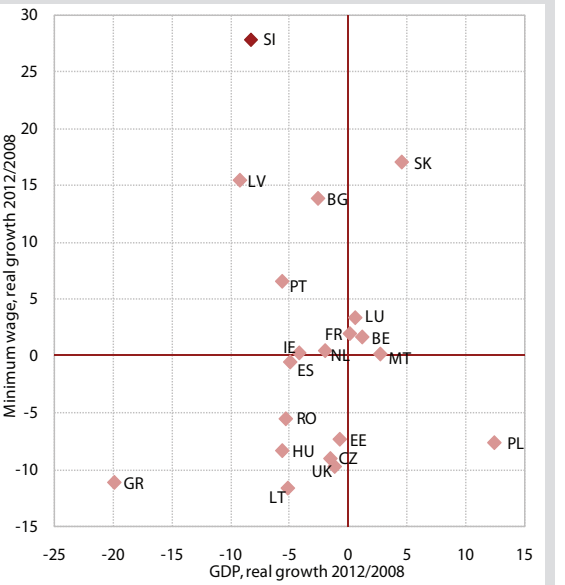
According to the ratio of the minimum to the average gross wage, which, in Slovenia, rose significantly during the last three years, Slovenia ranks at the top of EU Member States. The growth rates of the minimum and average gross wage in the period 1996-2009 were identical, while the crisis and an increase in the minimum wage in 2010 led to a considerable gap in terms of their growth. Consequently, the ratio of the former to the latter increased from 41.2% in 2009 to 50% in 2012, and is expected to continue to rise this year. In addition to Slovenia, a similarly high ratio was observed only in Malta (2012; 50.4%) and in Greece (2011; 50.1%), while in other Member States it ranges between 33% and 47%. Following the last legislative amendment of the minimum wage, the share of the minimum wage recipients, relative to the total number of employees, rose markedly (from 3% in 2009 to 7.5% in 2012).

Figure 6: **Growth of the minimum and average gross wage**



Source: SORS, calculations by IMAD.

Figure 7: **Growth of the minimum wage and GDP during the crisis**



Source: Eurostat, calculations by IMAD.

During the crisis, Slovenia recorded one of the greatest falls in economic activity among EU countries, as well as the largest increase in the minimum wage, which created siginificant pressures on cost-effectiveness of the economy and job losses. In 2008-2012, the increase in the minimum wage in real terms was almost 30% in Slovenia. Slovenia significantly stands out from other countries with regard to this trend. In the period since the beginning of the crisis, the minimum wage remained unaltered for several years in some countries (in Belgium, Bulgaria, Estonia, Lithuania, Ireland and Portugal), while in seven countries it even decreased in individual years (in the Czech Republic, Poland, Greece, Romania, Hungary, the United Kingdom and Latvia). In Slovenia, the real increase in the minimum wage in 2008-2012 otherwise had a positive effect on reducing wage inequality and the share of low-wage earners, but above all it created a lot of pressure on the cost-effectiveness of the economy and job losses[2]. This rise in the minimum wage may create further pressures in this direction, since this year's increase is substiantially higher than the forecast for this year's growth of the average wage.

[1] See IMAD (2013). Minimum Wage in Slovenia During the Crisis. Available at ttp://www.umar.gov.si/informacije_za_javnost/posebne_teme/

[2] See Working Paper 3/2010, IMAD (Brezigar et al.: Estimation of the Impact of the Minimum Wage Rise) and Economic Issues 2012 (Framework 2: Effects of the Rise in Minimum Wage in 2010 on the Loss of Jobs – Updated Estimation on the Labour Demand Function and Estimation of the Effects of the Rise in Minimum Wage and Labour Costs on Employment).

private sector wages would have been lower by more than half in this period, or by around 1.5 percentage points on average in the year as a whole.[11] Excluding these two factors, the response of the wage policy of the private sector to the crisis was significant, but it would have been even more pronounced

[11] In 2009, 2011 and 2012 by around 0.9 percentage points, whereas in 2010 by as much as 3.5 percentage points

Table 3: **Growth of average gross wage per employee, 2006-2012**

Year	Nominal growth of gross wage per employee, in %				Real growth of gross wage per employee, in %			
	Total	Private sector	Public sector	of which general government	Total	Private sector	Public sector	of which general government
2006	4.8	5.8	4.1	3.7	2.2	3.2	1.6	1.2
2007	5.9	6.0	6.9	4.1	2.2	2.3	3.2	0.5
2008	8.3	7.8	9.7	10.2	2.5	2.0	3.8	4.3
2009	3.4	1.6	5.3	7.0	2.5	0.7	4.4	6.1
2010	3.9	5.6	0.8	0.0	2.1	3.7	-0.9	-1.8
2011	2.0	2.6	1.0	0.0	0.2	0.8	-0.8	-1.8
2012	0.1	0.5	-0.9	-2.2	-2.4	-2.0	-3.4	-4.7

Source: SORS.

had the system of wage formation been to a larger extent based on company-level agreements rather than sectoral collective agreements. Following the period in which the movement of wages was mainly influenced by the increase in the minimum wage and the effect of changes in employment structure as economic activity slowed and companies were trying to maintain a competitive position, the average wage in the private sector has been stagnating ever since the end of 2011.

In the period since the beginning of the crisis, wage movements in the government sector, constituting the major part of the public sector, were first affected by the amended wage system, and later mostly by the government's austerity measures, which so far, have been mainly focusing on the level of wages, and not so much on employment restrictions. The latter is also an important factor in determining the wage bill, which is also reflected in the movements thereof in the private sector. A drop in employment in the private sector and a slow wage growth led to a decrease in the wage bill. In 2012, it dropped by 2.3% in nominal terms over 2008, while it rose by 10.7% in the government sector during the same period. The government sector did not stop employing during the crisis, but only slowed it down. Moreover, wage adjustment in the government sector was slower than in the private sector. In fact, the beginning of the crisis coincided with the initiation of an implementation of long planned wage reform aiming to eliminate wage disparities among individual occupational groups in the sector, which resulted in a relatively high wage growth precisely during the period when wages in the private sector already started to slow. In 2009, the wage growth was already slightly lower, since during the course of the year the first austerity measures were adopted, partially restraining growth, while bringing it to a complete halt in 2010 and 2011. Last year, the gross wage in the government sector was lower by 2.2% relative to the year before, which was primarily the result of the 3% decrease in wages with the Fiscal Balance Act that came into force in June. In June, wages of all civil servants were lowered by 8%, while at the same time the last two quarters of funds to eliminate wage disparities were paid. In addition to the fall in wages in the government sector, representing most of the public sector, the growth of wages in public companies also marginally slowed down. Significantly lower extraordinary payments of wages of these companies by the end of the year relative to the previous year slightly decelerated their wage growth, which still remained above average (2.0%)

The austerity measures of the government sector wage policy, which during the crisis, in addition to freezing or cutting the basic wages of civil servants, also abolished most of the elements designed to stimulate wages, result in greater equality among employees, which has had a rather non stimulating effect. Since April 2009, the payment of regular performance bonuses has been abolished. The funds allocated for payments based upon increased workload have also been limited ever since. From 2011, civil servants are no longer entitled to promotions. With the latest agreement between the government and the public sector trade unions, a compression of the wage scale was achieved, meaning that a greater decrease will be seen in higher wages than in lower wages. All the indicated measures are leading to increasingly smaller differences in the wages of employees and have a discouraging effect.

2. Labour market policy in 2008-2012

The majority of countries responded to the worsening of the labour market situation by strengthening active measures on the labour market and amending the unemployment insurance system. In 2009, all countries increased the level of funding of labour market policy measures, while in 2010 and 2011 some countries, influenced by fiscal consolidation, reduced these expenses, despite further deterioration of the labour market situation. At the onset of the crisis, a number of states increased access to benefits by reforming the unemployment insurance system, while at a later stage they mainly implemented reforms of the said insurance, aiming to return the unemployed to work. Changes in the implementation of active and passive measures on the labour market in the EU and Slovenia are briefly presented below.

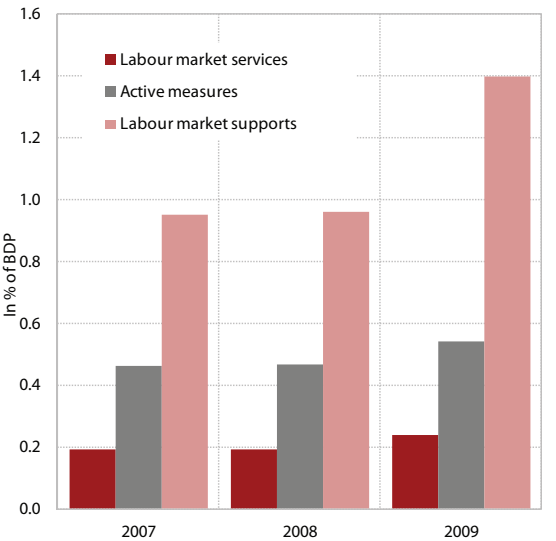
Slovenia's first response to the deteriorating labour market situation was the adoption of interventional acts aimed at preserving jobs and enhancing the implementation of active labour policy programmes, however, over time the policy became all the more passive. In 2009, two interventional acts were adopted aiming to preserve jobs, thus provisionally alleviating the drop in employment in Slovenia. The number of unemployed persons that participated in active labour policy programmes increased significantly in 2009 and 2010. After 2010, as the number of unemployed continued to increase and the unemployment benefits system became more favourable for the unemployed, the volume of labour market supports, in particular, began to increase. Slovenia falls within a group of countries which allocate a relatively low level of funds for labour market policy (measured in % of GDP).

2.1 Labour market policy measures in the EU

At the beginning of the crisis, a number of countries introduced provisional labour market measures, mainly encouraging shorter working hours. The provisional measures to tackle the crisis on the labour market comprise measures aimed at stimulating the shortening of working hours, enhancing active employment policy programmes and increasing accessibility to unemployment benefits. The majority of EU countries (20 out of 27) introduced different schemes stimulating shorter working hours. These schemes were implemented in the form of subsidies paid to the employer or employee from public funds or from a special fund co-financed also by the employers, or in the form of a partial unemployment benefit. Along with implementing this measure, some countries also stimulated and often subsidised the further training of employees on shorter working hours. Schemes were designed as a measure to preserve employment and encourage internal flexibility.

To strengthen programmes of activation and assistance to the unemployed, numerous states reorganised their public employment services. Aiming to enhance the efficiency of services, public employment services were reorganised in Lithuania, Luxembourg and Ireland already in 2009 and 2010, activation programmes were decentralised (Lithuania, Luxembourg) and the number of employees in public employment services were also increased (Sweden, Spain, France). New strategies to improve the matching and provision of quality services to unemployed persons were developed, whereby special programmes for individual groups of the unemployed were often formulated. Early activation programmes, particularly aimed at young people and the long-term unemployed, were developed in

Figure 8: **Expenditure on labour market policies in the EU, in % of GDP**



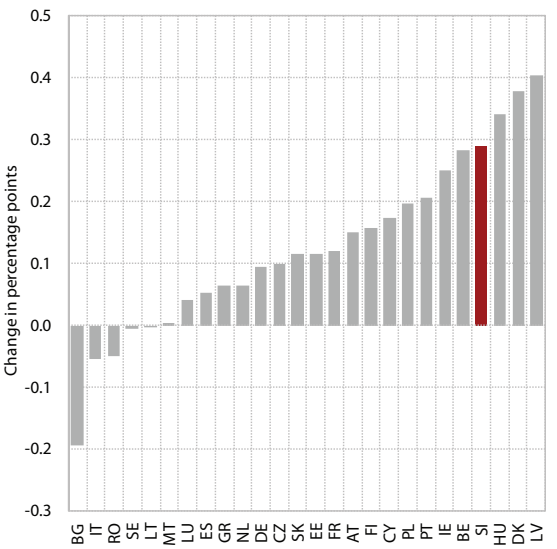
Source: Eurostat.
Note: *According to Eurostat's definition, the labour market policy interventions comprise (i) labour market services comprising all the activities of employment services together with any other publicly financed services for job seekers; (ii) active labour market measures comprising interventions which provide temporary support to disadvantaged groups on the labour market and which reinforce "activation" of unemployment and include training, rotation and job sharing programmes, employment incentives, supported employment and rehabilitation, direct job creation and start-up incentives; (iii) labour market supports which involve financial assistance intended to compensate for the shortfall in income due to wage loss and to serve as support in searching for a new job, or accelerate an early retirement.

France, Spain, Denmark, Ireland, Sweden, Portugal and Luxembourg. This was also reflected in higher expenditure for services on the labour market which, in the EU on average, grew by 16.8% in 2009, and by 7.6% in 2010

The overall expenditure for labour market policy also increased, with the most significant increase seen in expenditures for the labour market supports. In 2009, the total expenditure for labour market policy equalled 2.2% of GDP (0.57 percentage points more than in 2007). As shown in Figure 8, the highest increase was seen in expenditure for labour market supports, which includes the financial resources that are intended to compensate for the shortfall in income due to loss of salary and serve as support in searching for a new job (unemployment benefits) or accelerate an early retirement. The expenditure for labour market supports totalled 1.4% of GDP in 2009 in the EU, 0.45 percentage points more than in 2007.

During the crisis, the majority of countries increased expenditure on active labour market policy measures. In 2009, countries in the EU used, on average, 0.54% of GDP for such measures, which is 0.08 percentage points more than in 2007. This expenditure rose by 9.5% in 2009 and was 18.4% higher in 2010 than in 2007, according to our estimates.[12] In 2010, only Romania, Bulgaria and Italy appropriated fewer funds for active labour market policy measures than in 2007.

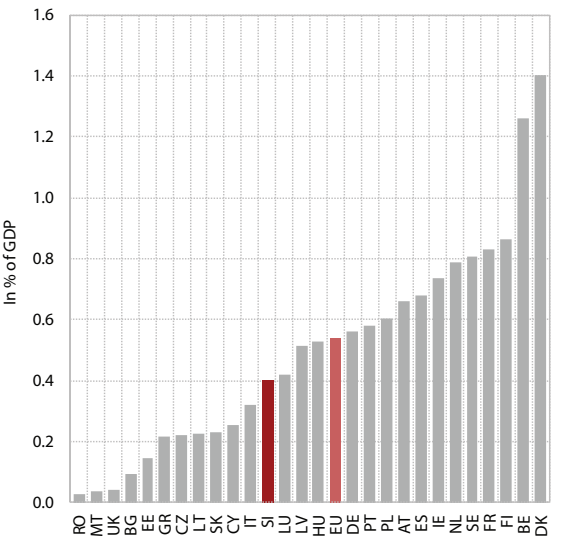
Figure 9: **Change of expenditure on active labour market policy measures (relative to GDP) in 2007-2010, in percentage points**



Source: Eurostat; calculations by IMAD.

[12] The estimate is based on the assumption that in the United Kingdom (no data were available) expenditure on active measures in 2010 was equal to that in 2009.

Figure 10: **Expenditure on active labour market policy measures in the EU in 2010, in % of GDP**

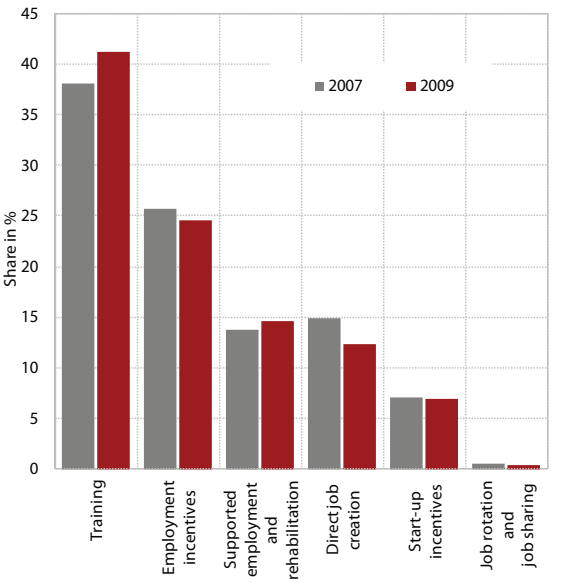


Source: Eurostat.

Differences between countries in the level of active expenditure increased in 2009. The highest level of expenditure on active measures during and before the crisis was recorded in Denmark, which is also one of the countries where this expenditure increased the most (Figure 10). On the other hand, Romania, Bulgaria and Malta recorded the lowest levels of such expenditure, which even during the crisis, did not increase.

Within the framework of the active labour market policies, the majority of countries increased training and education opportunities. The measures were

Figure 11: **Structure of expenditure on active measures by purpose in the EU in 2007 and 2009, in %**

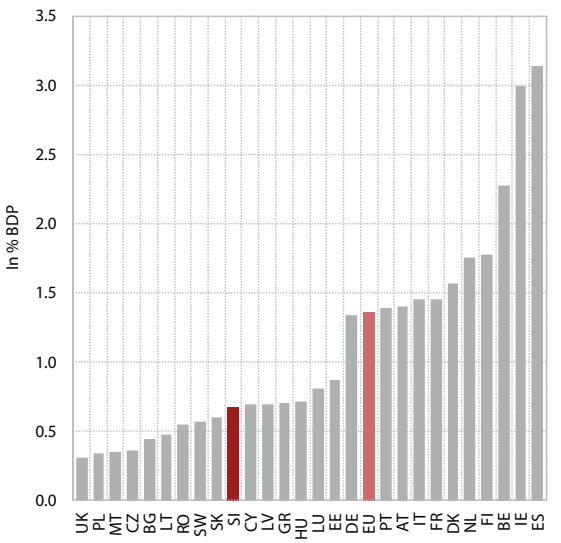


Source: Eurostat; calculations by IMAD.

aimed at maintaining employability, improving labour market matching and enhancing skills. The purpose of these measures was to facilitate the transition from education to employment where a number of countries used apprenticeship schemes and strengthened their worker training programmes. As seen in Figure 11, in 2009 the largest part of expenditure in the EU was used for such training (41.2%), which also saw the greatest rise compared to 2007.

During the crisis, a number of countries reformed their unemployment insurance system. Unemployment insurance systems play an important role in providing income security to the unemployed. Thus, several states reformed their insurance systems aiming to enhance automatic stabilizers and support aggregate demand. Unemployment benefits for unemployed people in the initial phase of unemployment were increased in Belgium, the Netherlands, Finland, Greece, Bulgaria, the Czech Republic and Poland. In the last few years, the duration of benefits was extended in Romania, Latvia and Finland, while in Ireland, the Czech Republic, Sweden and the Netherlands it was reduced. By adopting changes, the countries were also increasing accessibility to benefits (for more information see Chapter 3.1).

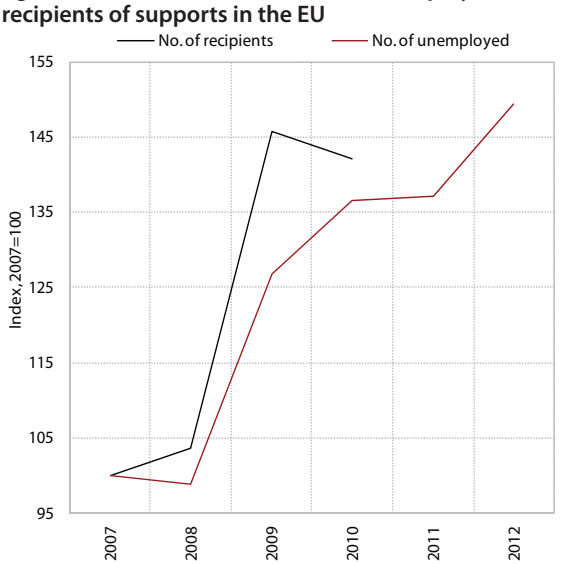
Figure 12: **Expenditure on labour market support in the EU in 2012, in % of GDP**



Source: Eurostat.

Due to changes in the systems and the rising number of the unemployed, expenditure on labour market support rose faster than other expenditure. In 2007, the EU countries on average used 0.96% of GDP for labour market support (unemployment benefits and other forms of financial assistance), and 1.37% of GDP in 2010. As shown in Figure 13, the number of recipients of support was up by 42% in 2010 relative to 2007, whereas the number of unemployed rose by 36.2%. The rapid rise in the number of recipients of support is a result of the policy aimed at offering the unemployed greater accessibility to benefits. According to the labour force survey, in the EU the share of the unemployed receiving benefits thus increased to 80% in 2009 (10 percentage points more than in 2007), which was also due to a high inflow of unemployed persons qualifying for unemployment benefits. However, in 2010 the said share of unemployed persons dropped again to the level seen in 2008 (around 73%). The expenditure on labour market support rose more than other expenditure for labour market policies. In 2010, the highest level of this expenditure was observed in Spain which also recorded the highest unemployment rate in the EU (3.14% of GDP), whereas the lowest rate was seen in the United Kingdom. In 2007-2010, the highest increase in expenditure on support was witnessed in Estonia (almost seven-fold).

Figure 13: **Trends in the number of unemployed and recipients of supports in the EU**



Source: Eurostat; calculations by IMAD.

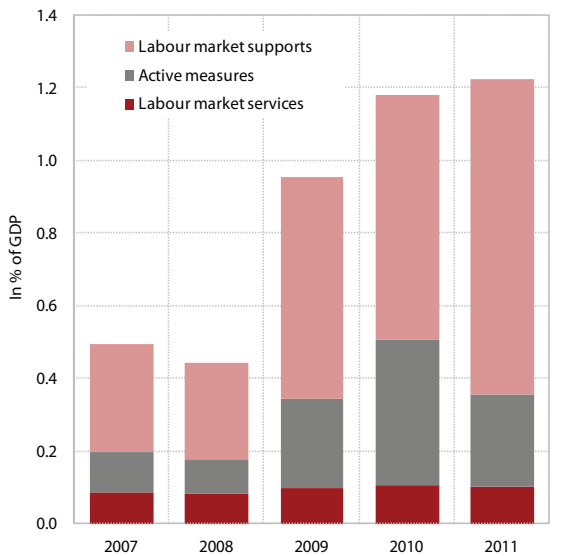
2.2 Labour market policy in Slovenia

Slovenia's first response to deteriorating situation on the labour market was the adoption of interventional acts aimed at preserving jobs and enhancing the implementation of active labour policy programmes, however over time the policy became all the more passive. In 2009 two intervention acts were adopted aiming to preserve jobs, thus provisionally alleviating

the drop in employment in Slovenia[13]. The share of people included in these schemes was highest in mid-2009 (around 4.8% of the total active population according to the statistical register (for more see Economic Issues 2011)). The two schemes, intended to preserve jobs came to an end by the end of 2010. The number of persons participating in the active employment policy programmes in 2009 grew by 77% when compared to 2008, and by a further 38% in 2010. After 2010, as the number of unemployed rose even further and the unemployment benefits system became more favourable, the volume of passive financial support started to increase.

Slovenia supports the labour market policy, yet with significantly fewer financial resources than, on average, other EU countries. In 2009, Slovenia's total expenditure on labour market policy equalled 0.96% of GDP, while in the EU, on average, twice as much was spent (2.18% of GDP). Relatively speaking, the greatest gap in expenditure on labour market services was seen in 2009. Upon examination of the results of international surveys regarding the efficiency of labour market policy, we may conclude that modest levels of such expenditure reduce the possibilities to significantly influence the situation on the labour market with employment policy. Kluve (2006) in fact notes that different counselling and job search assistance programmes for the unemployed during their job searching phase, i.e. the programmes that combine "services and sanctions", are the most successful in increasing the participant's employability. These programmes include all activities that increase the effectiveness and intensity of job searching and counselling for the unemployed, as well as sanctions against those that are not particularly active or fail to satisfy the imposed obligations.

Figure 14: **Total expenditure on labour market policies in Slovenia, in % of GDP**



Source: Eurostat.

The share of expenditure on labour market supports to total expenditure on labour market policies increased markedly during the crisis. In 2011, the total labour market policy expenditure rose by 167% over 2008, with expenditure on supports rising the most (by 215%). The share of expenditure on supports to total expenditure climbed to 70.1% in 2011, 11 percentage points more than in 2008. In 2009, (the latest available figures for the EU) the share of expenditure on supports totalled 63.8% in Slovenia, which is slightly less than the EU average (64.1%). Due to increased expenditure on labour market supports, the total labour market policy expenditure in Slovenia did not decline in 2011, totalling 1.23% (0.78% more than in 2008), while expenditure on supports amounted to 0.87% of GDP (0.6 percentage points more than in 2008). Nevertheless, Slovenia allocates substantially fewer funds for labour market support than the EU average.[14]

Strengthened implementation of active labour policy programmes and the implementation of intervention acts resulted in a significant increase in expenditure on active labour market measures in 2009 and 2010, but since 2010 this expenditure has been falling. The expenditure on active measures more than doubled in 2009, largely as a result of acts of interventions aimed at preserving jobs.[15] The rapid growth of this expenditure continued in 2010, as it rose by a further 41.8% according to Eurostat data. In 2009 and 2010, the share of expenditure on active labour market measures thus increased, but has decreased in subsequent years. In 2011, the volume of expenditure on active measures dropped by 35.8%, and by our estimates spending cuts also continued in 2012.

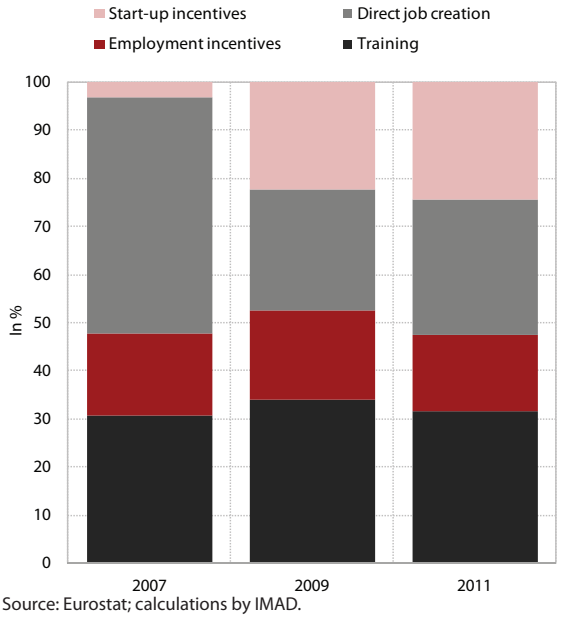
In 2009, the structure of expenditure on active measures witnessed a rise in the share allocated for training programmes, similar to those in the EU, yet with regard to start-up incentives, Slovenia stands out. The share of funds for start-up incentives rose markedly in Slovenia, which is the result of the introduction and expansion of schemes subsidizing self-employment of the unemployed. Other EU

[13] In January 2009, Slovenia adopted the Partially Subsidising of Full-time Work Act. At the end of May, the Government also adopted the Partial Reimbursement of Payment Compensation Act, regulating the partial reimbursement of wage compensation for employees on temporary layoff ("on waiting" at home).

[14] In 2009, the expenditure on labour market support on average represented 1.4% of GDP in the EU, and 0.61% of GDP in Slovenia.

[15] In 2009, around EUR 32 m was used for both schemes aimed at preserving jobs.

Figure 15: **Structure of funds for active labour market measures in Slovenia**



Source: Eurostat; calculations by IMAD.

countries did not increase the amount of funds intended for start-up incentives during the crisis (see Figure 11). Even though the ESS considers the measure aimed at promoting self-employment as highly successful, it would be sensible to also carry out an evaluation of the programme that would show the success and factors of success of the unemployed in moving to self-employment.

After the substantial increase in the number of people involved in active labour market measures in 2009 and 2010, the number dropped sharply in 2011 and 2012. In 2009 and 2010, the number of participants in active employment policy measures more than doubled, compared to 2008. The number of unemployed persons participating in active employment policy programmes slumped, even though the structural problems on the labour market further increased in 2011 and 2012. This was also seen in a reduced number of unemployed persons participating in active employment policy measures, which after the increase recorded in 2009 and 2010, fell sharply in 2012. The share of unemployed persons participating in these programmes amounted to 60% in 2010, which is twice as much as in 2007. However, in 2012 this share was even lower than before the crisis (26.5%), despite the fact that labour market mismatch increased during the crisis.

A considerable fall in the share of long-term older and low-skilled unemployed persons was seen in 2011 and 2012, which is problematic from the aspect of eliminating structural problems. To analyse the scope and targets of the active employment policy programmes, we calculated the ratio of the number of unemployed people from a certain group participating in the active employment policy programmes to the total number of unemployed persons in this group, naming it the participation rate, which serves as an approximate indicator of

Table 4: **Participation rate of the unemployed in active employment policy programmes, in %**

	2007	2008	2009	2010	2011	2012
Total unemployed persons (UP)	25.7	37.1	48.3	59.2	35.0	26.5
UP aged over 50	9.2	15.9	18.5	20.5	12.9	12.6
UP for one or more years	30.7	33.2	33.5	45.6	25.4	22.4
UP with low education	21.3	22.0	30.3	35.6	21.0	15.5
UP aged below 26	34.9	42.9	53.3	63.6	37.6	28.9
UP recipients of benefits	7.2	14.4	25.4	29.3	21.3	14.9
UP recipients of social benefits	31.5	35.5	71.3	48.3	25.2	17.3

Source: ESS; calculations by IMAD.

Table 5: **Participation rate of the unemployed by type of programme, in %**

	2007	2008	2009	2010	2011	2012
Training and education	19.4	20.5	24.9	28.7	15.6	11.2
Employment incentives	0.6	1.6	5.2	4.3	2.5	1.7
Job creation	5.0	7.2	5.6	6.7	2.8	6.0
Promotion of self-employment	0.6	7.7	12.6	19.4	14.2	7.5
Total	25.7	37.1	48.3	59.2	35.0	26.5
Lifelong career orientation	8.2	8.9	11.4	11.8	9.2	8.2

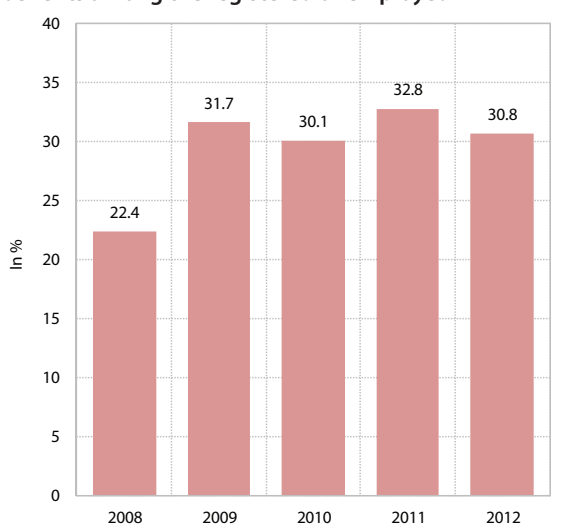
Source: ESS; calculations by IMAD.

participation in an individual group. As shown in Table 4, in 2010-2012 a strong decline was recorded in the participation rate of the unemployed younger than 26 and older than 50 years, and the low-skilled and the long-term unemployed.[16]

During the crisis, the unemployed were most often included in education and training programmes. The share of unemployed persons participating in active employment policy programmes peaked in 2010. The highest participation of the unemployed in training and educational programmes by programme type was observed in 2010 (28.7%), but this subsided considerably over the last two years. This is indeed inappropriate, considering the growing imbalances on the labour market. The analyses of the effectiveness of active employment policy programmes (Kluve, 2006) show that practical training programmes and other short-term training programmes aimed to equip people with new knowledge and skills have positive effects on employability and exit rates from unemployment.

As in other countries, the number of recipients of unemployment benefits rose faster than the number of the unemployed. In 2012, the average number of people registered as unemployed in Slovenia increased by 74.3% over 2008, while the number of recipients of unemployment benefits was up by 139%. The trend in the number of recipients of unemployment benefits was, in addition to the structure of the unemployed (a large part of older population), also affected by changes in eligibility criteria for benefits, which is elaborated upon in more detail in Chapter 3.2.1.

Figure 16: **The share of recipients of unemployment benefits among the registered unemployed**

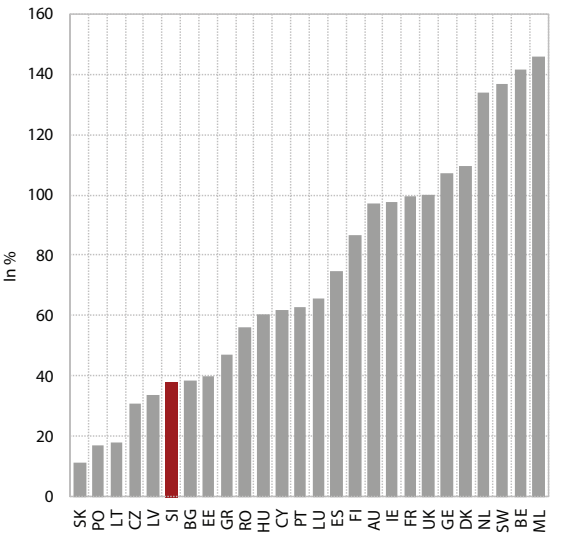


Source: ESS; calculations by IMAD.

[16] Long-term unemployed persons are those who have been without employment for a year or more.

The share of unemployed persons receiving unemployment benefits in Slovenia increased during the crisis, yet it still lags way behind the EU average. The biggest increase in the share of the registered unemployed receiving unemployment benefits in Slovenia was recorded in 2011, totalling 32.8%, which was 10 percentage points more than in 2008. If we compare the EU states in terms of unemployment benefit coverage, which is calculated as the ratio of the number of recipients to the number of the registered unemployed, we can see that Slovenia is ranked among the countries with low coverage rates.

Figure 17: **Unemployment benefit coverage rate, in %**



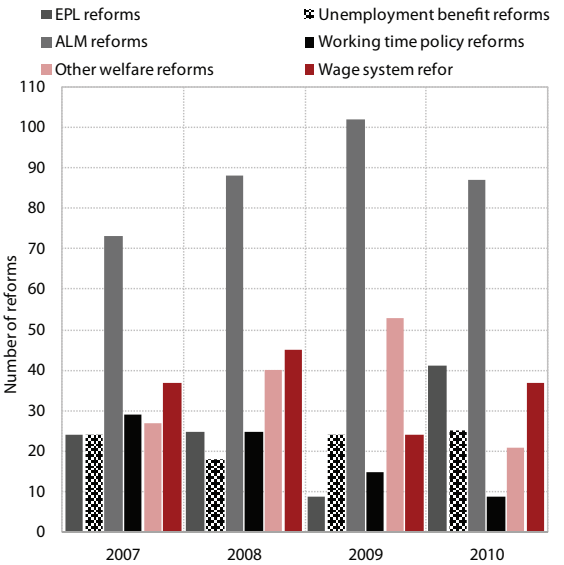
Source: Eurostat; calculations by IMAD.

Note: The unemployment benefit coverage rate is calculated as a ratio of the number of recipients of benefits to the number of registered unemployed persons. The coverage may exceed 100, since in some countries also people in part-time employment still receive unemployment benefits even though they are no longer registered as unemployed persons.

3. Changes in the labour market regulation in 2008-2013

The impact of the regulation of the labour market on its performance regained importance over the course of the crisis. The impacts of labour market institutions are often at the centre of empirical and theoretical debates. With an increase in the number of problems on the labour market, labour market reforms were brought back rapidly on the agenda of economic policy makers. This chapter will focus on the changes concerning employment protection and insurance against unemployment, i.e. the institutions that underwent frequent reforms during the crisis period. The following is a brief overview of the relevant reforms carried out in the EU, as well as a presentation of reforms in Slovenia, including an assessment of the impacts of changes made this year.

Figure 18: **Number of major reforms on the labour market of EU Member States**



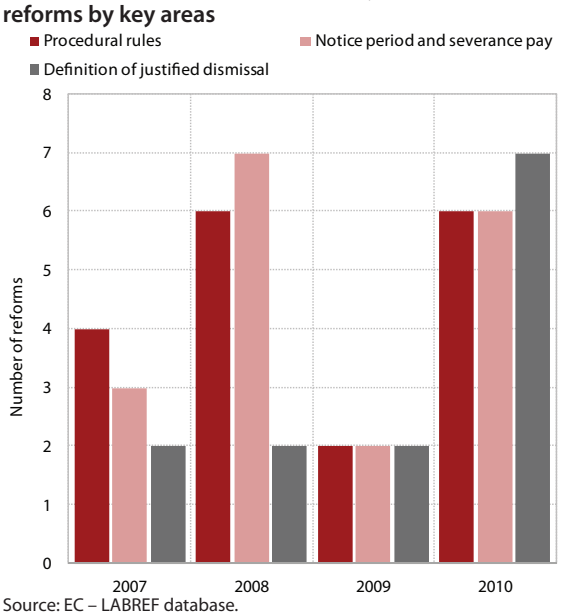
Source: EC – LABREF database.

3.1 Reforms on the EU labour market

During the course of the economic crisis, the number of labour market reforms in the EU rose. The economic crisis and the consequent worsening of conditions on the labour market prompted the EU Member States to adopt numerous reforms. The situation in the EU economies tightened toward the end of 2008; the countries in general responded by adopting reforms in the field of active labour market policy (job-search assistance, additional education and training, job-creation subsidies, etc.), interventions in the wage systems (freezing or cutting wages in the public sector, adjustment of the minimum wage), and other welfare-centred reforms (entitlement to social assistance and other subsidies). The first fiscal stimuli aimed at mitigating the impacts of the deceleration of economic activity on the labour market included incentives for labour demand, supports for job-seekers, and financial assistance to companies coping with lower demand. As indicated in Chapter 2.1., in addition to the intense implementation of active measures on the labour market, a significant share of anti-crisis measures comprised changes in the system of unemployment benefits. In 2010, in view of the growing need for fiscal consolidation in several countries, the number of reforms concerning the income status of the unemployed and welfare preservation began to decrease; focus was instead put on structural reforms regulating long-term deficiencies and imbalances of the labour market, such as reforms relating to employment relations and, in particular, employment protection, the number of which grew considerably compared to the pre-crisis period.

Countries are trying to reduce structural imbalances on the labour market with reforms of employment protection legislation. Employment protection legislation comprises rules and procedures regulating the dismissal of individuals, and groups of individuals, and their fixed-term and permanent employment. The respective reforms are intended to reduce structural imbalances on the labour market. It is, therefore, no

Figure 19: **Number of adopted employment protection reforms by key areas**



Source: EC – LABREF database.

surprise that employment protection reforms were undertaken mainly by countries with traditionally large labour market structural imbalances. Less strict dismissal rules were adopted in Italy, Portugal and Spain, the reasons for justified dismissal were broadened in Spain and Portugal, and longer probationary periods were introduced in Romania and Slovakia. Likewise, Portugal, Spain, Greece, Slovakia, the Czech Republic and the United Kingdom reduced the costs of dismissals and defined clearer criteria for justified and unjustified dismissals. Romania and Lithuania enabled the possibility to extend fixed-term contracts, Romania, Slovakia and the Czech Republic prolonged the time of the possible duration thereof, while the Czech Republic and Slovakia increased the number of possible successive contracts.

The introduced reforms regulate individual and collective dismissals and temporary employment contracts. Empirical studies (OECD 2004, EC 2012) generally confirm that less rigid redundancy procedures and rules improve the labour market capacity to adjust to changing economic conditions, and reduce segmentation and long-term unemployment. Reforms in the field of employment protection were carried out by numerous countries:

- ***Spain***, where the unemployment rate is among the highest and the labour market is heavily segmented, passed a comprehensive reform of the labour market in 2012, including changes of the employment protection legislation. The country set clear criteria for justified dismissal, abolished the companies' obligation to pay off the individuals involved in court proceedings against the company concerning the justification of dismissal, and reduced severance payments in cases of justified dismissals, while in case of fixed-term contracts, severance payments slightly increased. A new form of permanent contract was launched, which comprised a probationary period of one year and was intended for jobs on the basis on state subsidies to employ vulnerable groups. The prior administrative authorisation required for collective dismissals was removed.

- ***Italy***, which is also tackling labour market segmentation, adopted a package of reforms to enhance employment and dismissal flexibility. As regards flexibility of employment, Italy increased the admissible number of apprenticeships within firms, while on the other hand, raised social contributions for temporary employment, to make the latter less appealing and similar to regular forms of employment. In terms of flexibility of dismissal, Italy tightened the conditions for reemployment in cases of unfair dismissal on economic or disciplinary grounds, whereby individuals will be more often entitled to compensation.

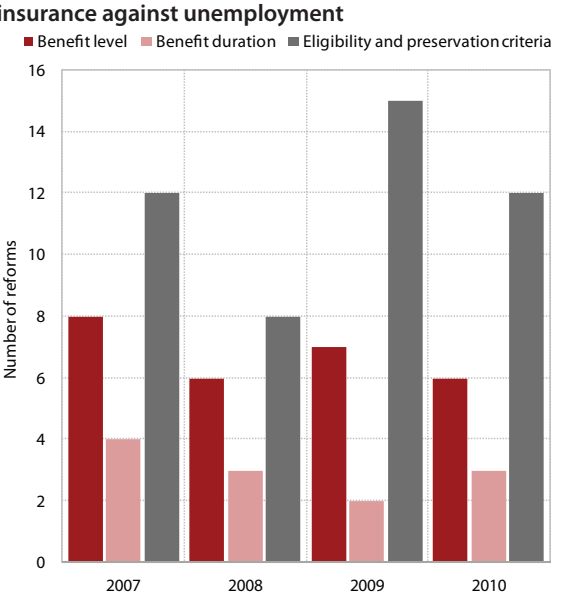
- ***Poland***, where rigidity (measured by the employment protection legislation index) is not particularly notable, records one of the largest shares of temporary employment in the EU. This is a consequence of numerous contracts being drawn up under civil, rather than labour law. In order to minimise the appeal of such contracts, Poland introduced legislative amendments regulating in detail the conditions under which a specific form of contract can be concluded.

- ***France*** passed a reform with the view of enhancing the protection of both companies and workers and reducing labour market segmentation; a special emphasis is placed on the budgetary neutrality of reforms. The country introduced the possibility of an in-company agreement on the temporary reduction of wages and working hours in exchange for job preservation; if the workers refuse such agreement, they may be dismissed on economic grounds.

- in ***the Netherlands***, an agreement was reached between the government and social partners to pass a reform providing for severance pay for all dismissals, reduced by and depending on, the individual's years of service rather than age. Moreover, the country restricted the maximum duration of successive fixed-term employment contracts and abolished probationary periods in the event of very short-term contracts.

The number of reforms concerning unemployment benefits in the EU did not change notably over the 2008–2010 period. In 2008, their number somewhat decreased compared to the year before since in

Figure 20: **Number of adopted reforms in the area of insurance against unemployment**



Source: EC – LABREF database.

several countries economic activity slowed down only in the second part of the year and countries began to implement the reforms only in 2009. As a result, the number of reforms involving unemployment benefits rebounded slightly in 2009 and 2010. As a general rule, reforms in the field of unemployment benefits relate to the level of benefits, the duration of benefits, and the eligibility and preservation criteria. Empirical studies (OECD 2011) indicate lower benefit levels imply lower unemployment rates, and that the restriction upon the duration of benefits received also reduces the persistence of unemployment. Hence, reforms concerning unemployment benefits were introduced with the aim either to improve start-up incentives while supporting fiscal consolidation, or to stabilise the income security of those who lost their jobs. Incentive-friendly measures including the reduction of the unemployment benefit level were adopted by Ireland, Latvia, Romania, Portugal and Slovenia, while the unemployment benefit level was increased in Belgium, Bulgaria, Estonia, Poland and Italy. Sweden opted for lowering the accrual percentage, in proportion to the time spent in unemployment (Hemstrom, 2011). Cuts in benefit duration were introduced in Portugal, Hungary, Slovakia, Finland, the Czech Republic and Ireland, whereas in Denmark, Latvia and Romania benefit duration was lengthened.

3.2 Changes in the labour market regulation in Slovenia

Since the onset of the crisis, Slovenia has often changed its unemployment insurance system; in 2013, it also introduced changes in the field of employment protection. With the adoption of the Labour Market Regulation Act in 2010, Slovenia changed eligibility criteria and increased the level of unemployment benefits. The above Act, which improved the income security of the unemployed, entered into force in 2011 when other countries were already adopting reforms to increase work incentives. Greater income security of the unemployed was in force for a relatively short period of time, with the amount of benefits already being reduced in mid-2012 due to fiscal consolidation.

3.2.1 Changes in the unemployment insurance system

In 2008-2013, Slovenia made several changes in the field of unemployment insurance. The main change was brought about by the adoption of the Labour Market Regulation Act, which came into force on 1 January 2011. The new Act, primarily aimed at enhancing the income security of job-seekers (a move towards flexicurity), also provided new solutions in the field of active employment policy. Regarding unemployment insurance, the Act broadened the circle of compulsory insurance holders and those who can be voluntarily insured against unemployment, as well as beneficiaries of unemployment benefits.

The Labour Market Regulation Act eliminated some of the deficiencies of unemployment insurance. Thus, it improved youth access to unemployment benefits and slightly enhanced the income security of the unemployed. One of its major achievements was the broadening of the circle of unemployment benefit beneficiaries (a beneficiary is any unemployed person who, prior to becoming unemployed, had been insured for at least nine months during the past two years; previously: at least 12 months in the past 18 months). Moreover, the Act raised the value of the benefit for the first three months of entitlement (from 70 to 80% of the base, whereby the base is the average monthly wage received over a period of eight months prior to unemployment). The duration of benefit for older unemployed persons was extended by one month.

Despite the intention of the Labour Market Regulation Act to increase the income security of the unemployed (i.e. the amount and accessibility of benefits), the amount once again fell in the middle of 2012. Dolenc et al. (2012) noted that the new Act increased the unemployment replacement rate, while the probability of receiving the benefit (accessibility) improved only slightly. As seen in Chapter 2.2., expenditure on supports in Slovenia rose significantly in 2011, also as a result of the new Act. Table 6 below indicates that the Fiscal Balance Act reduced the level of accrual percentage determining the amount of benefit for the period following the first three

Table 6: **Accrual percentage of unemployment benefit**

Benefit duration	amount of benefit as a % of previous wage			
	Employment and Insurance against Unemployment Act (1998-2010)	Labour Market Regulation Act 2011 until Fiscal Balance Act - June 2012	Fiscal Balance Act	Labour Market Regulation Act - April 2013
first three months	70	80	80	80
after three months	60	60		
4th-12th month			60	60
after 12 months			50	50

Source: Employment and Insurance against Unemployment Act, Labour Market Regulation Act, Fiscal Balance Act, Act Amending the Labour Market Regulation Act

months of unemployment. Likewise, it decreased the maximum and minimum benefit.

This year's change in unemployment benefits aims at improving the accessibility for young people. The amendments to the Labour Market Regulation Act, in force since mid-April 2013, additionally introduce the possibility for people under 30 years old to obtain unemployment benefits for two months, provided that in the prior 12 months they had had 6 months of paid insurance coverage.

Table 7: **Insurance period as a condition for entitlement to unemployment benefits**

Insurance period	Benefit duration (in months)		
	Employment and Insurance against Unemployment Act (1998-2010)	Labour Market Regulation Act 2011	Act Amending Labour Market Regulation Act - April 2013
6 months			2(c)
9 months - 5 years		3(a)	3
1-5 years	3(b)		
5-15 years	6	6	6
15-25 years	9	9	9
25 years and more	12	12	12
people aged over 50 with more than 25 years of insurance	18	19	19
people aged over 55 with more than 25 years of insurance	24	25	25

Source: Employment and Insurance against Unemployment Act, Labour Market Regulation Act, Fiscal Balance Act, Act Amending the Labour Market Regulation Act.
Note: (a) 9 months of insurance in the past 24 months, (b) 12 months of insurance in the past 18 months, (c) 6 months of insurance in the past 12 months.

An important new feature of the Labour Market Regulation Act is the possibility of integrating workers whose employment is at risk, into life-long career counselling. In order to prevent the transition to unemployment or enable the fast transition from unemployment to new employment, the Labour Market Regulation Act (2011) allowed workers whose employment was at risk to also register at the Employment Service as job-seekers.[17] These workers are entitled to in-depth career counselling at the Employment Service. Unfortunately, however, such form of early intervention did not evolve into practice owing to limited human resources of the Employment Service. Pursuant to the amendments to the Labour Market Regulation Act and the new Employment Relationships Act of 2013, employers must allow workers, who have received notice of dismissal on economic grounds or due to a lack of capability, to be absent from work at least one day per week to participate in the labour market programmes. Such a solution is indeed positive in order to increase the possibilities of a faster re-entry into the work force. Rather unusual, on the other hand, is the solution that the above absence from work is paid for by the workers themselves as the unemployment benefit is reduced by the time of such absence. The new provision should be defined in more detail by implementing regulations in order to avoid abuse and ensure a broad and effective use thereof.

3.2.2. Changes regarding employment protection

The latest changes in labour market regulations in Slovenia were brought about by the new Employment Relationships Act and by the amendments to the Labour Market Regulation Act adopted at the beginning of the year. Both acts came into force mid-April 2013 and relate to employment protection. The purpose of the amendments was to: (i) reduce labour market segmentation, (ii) enforce the concept of flexicurity, and (iii) increase the efficiency of labour law protection and abuse prevention. The new Labour Market Relations Act simplifies the dismissal procedure in the event of an individual dismissal of a worker in permanent employment, reduces the costs of dismissals of workers in regular employment (notice period and severance pay), and applies some new restrictions to the drawing up of fixed-term contracts. The amendments to the Labour Market Regulation Act introduce the possibility of temporary and occasional work of pensioners and improve the accessibility of unemployment benefits for young people under 30.

With the aim of reducing labour market segmentation, the costs of dismissal of workers in regular employment were decreased, while new restrictions were applied to the conclusion of fixed-term contracts. To minimise the differences between fixed-term and permanent employment, the new Employment Relationships Act: (i) introduces severance pay in cases of termination of fixed-term contracts drawn up for one year or less, in the amount of 1/5 of the average monthly wage[18], (ii) introduces additional restrictions upon the chaining of fixed-term contracts for the same work, with a legal definition of

[17] A job-seeker whose employment is at risk is any worker who has received notice pending termination of regular employment or whose job - as indicated by the employer's documentation - is to become redundant, or any person whose fixed-term employment contract is to terminate within three months.

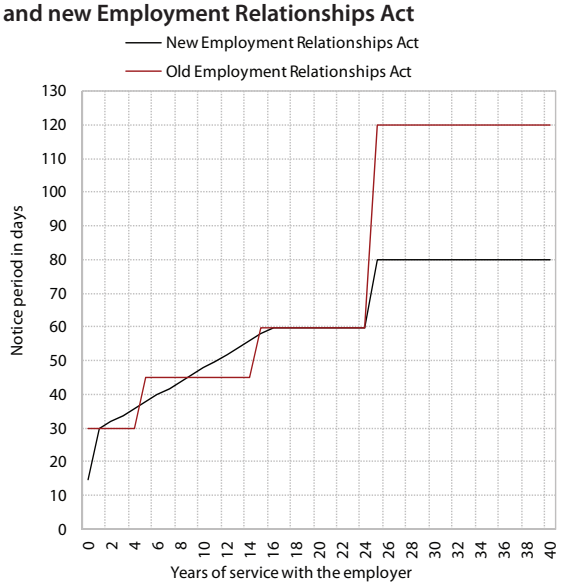
[18] Article 79 of the new Labour Relations Act.

what the "same work" means,[19] (iii) sets limitations to fixed-term contracts in case of agency workers[20], (iv) shortens the maximum period of notice of dismissal in case of regular employment, and (v) decreases severance pay for workers at 5-10 and 15-20 years of tenure.

The new Employment Relationships Act simplifies dismissal procedures. The new Act simplifies the regulation of objection procedures and abolishes the legal form of a (written) invitation to offer a defence, which had to have prescribed content and be delivered personally. In case of dismissal on economic grounds, workers no longer need to be notified in advance of the intended dismissal. The possibility of delaying the effects of termination of an employment contract based on the negative opinion of the workers' representatives is now limited to the above workers only, while previously it had applied to all. Likewise, there has been a reduction regarding the delay before a notice can take effect. All the above lowers the employment protection score, measured by the OECD employment protection legislation index (see Chapter 3.2.2.1).

The new Employment Relationships Act modified notice periods, which even prior to the implementation of this reform had not exceeded the OECD average. The amount of severance payments and the duration of the notice period represent a significant expense to the company, which influences the adjustment to the optimum level of employment and reduces dismissals, yet at the same time also hinders new employment (Mortensen and Pisarides (1994)). The maximum notice period was reduced from 120 to 60 or 80 days.[21] As indicated in Figure 21, notice periods declined considerably for workers with less than 1 year of service (from 30 to 15 days) and for those with more than 25 years of service with the employer (from 120 to 80 days), while increasing for workers with 2-4 and 9-14 years of service. Since data on the distribution of workers by duration of service are only available for the public sector, it was possible to calculate that shorter notice periods now apply for more than a half of public employees, while 23% of them are subject to longer notice periods.

Figure 21: **Comparison of notice periods in case of dismissal on economic grounds according to the old and new Employment Relationships Act**

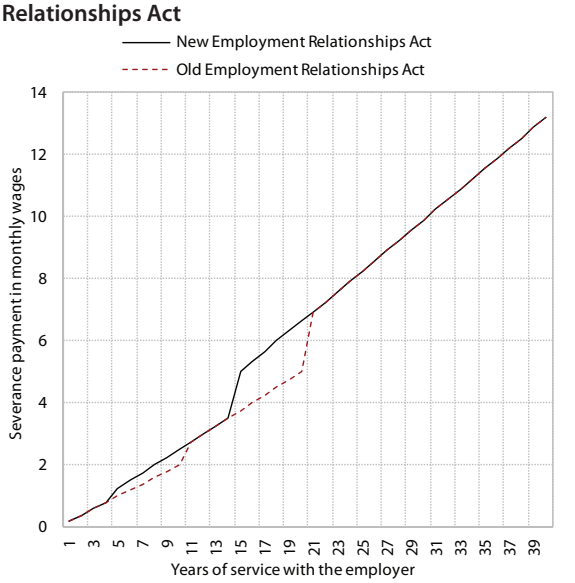


Source: Old and new Employment Relationships Act.

Notice periods in Slovenia are below the OECD average. An international comparison of notice periods is provided by the OECD database on employment protection covering notice periods and severance payments for three categories of workers, namely at 9 months, 4 years and 20 years of tenure. A comparison of notice periods for the above categories of workers among OECD countries reveals that notice periods in Slovenia, according to both versions of the Employment Relationships Act, are below the OECD average (see Table P1 in Appendix).

The new Employment Relationships Act also slightly reduces severance payments. The maximum amount of severance payment continues to be 1/3 of the

Figure 22: **Amount of severance payment by years of service according to the old and new Employment Relationships Act**



Source: Old and new Employment Relationships Act.

[19] Article 51 of the new Labour Relations Act.

[20] The Employment Relationships Act limits the number of agency workers hired, which may not exceed 25% of the workers employed by the employer (Article 59).

[21] For more than 25 years of service with the employer, the notice period is 80 days.

wage for each year of service with the employer, but can only be claimed after 25 years of service. As seen in Figure 22, severance payments were reduced for workers with 5-10 and 15-20 years of tenure. Data on the distribution of workers by years of service in the public sector reveal that the new Act decreased severance payments for 31.6% of public employees.

As regards the amount of severance payment, Slovenia departs from the OECD average only in the category of older workers. A detailed comparison of severance payments in cases of dismissal of workers with 9 months, 4 years and 20 years of tenure shows that Slovenia ranks among the countries with an above-average amount of severance pay only regarding dismissal of workers with 20 years of tenure, who, according to the old Employment Relationships Act, were entitled to 6.7 monthly wages (according to the new Act: 5 monthly wages). Regarding dismissal of workers with 20 years of tenure, Slovenia remains above the OECD average even after the entry into force of the new Employment Relationships Act. (see Table P1 in Appendix).

3.2.2.1 Assessment of this year's changes in the labour market regulation

This year's changes to the labour market regulation were made in the right direction and could have positive, although modest impacts on employment. Amendments in the field of protection of regular employment were aimed at increasing flexibility, as they lowered dismissal costs for some categories of workers and simplified the dismissal procedure. As another objective thereof was to reduce labour market segmentation, some amendments were adopted that might act in the sense of reducing flexibility (e.g. severance payments for fixed-term employment and quotas for temporary recruitment of agency workers). The adopted amendments are thus the result of pursuing two different fundamental goals (increasing flexibility and reducing segmentation) and the compromises reached in negotiations between the social partners. Nevertheless, the amendments were indeed a step in the right direction, since the econometric estimates of effects of the adopted amendments reveal positive, yet modest effects on employment.

The employment protection index enables a comparison of labour market regulation among selected countries. For international comparisons of labour market regulations and for the classification of countries in terms of employment protection, OECD experts developed what is known as the employment protection legislation (EPL) index (OECD, 1999). The index incorporates 21 elements of labour market regulation that can be combined into three groups or sub-indices: (i) protection of permanent workers against individual dismissal;[22] (ii) regulation of temporary forms of employment[23] and (iii) specific requirements for collective dismissal[24]). The weighing of 25 indicators of labour market regulation, assessed on a scale of 0 to 6, gives the total EPL index. The EPL index is valued on a scale of 0 to 6, whereby higher values indicate a more rigid labour market regulation i.e. greater employment protection (OECD 1999).

To our estimates, the new regulation alters more than a third of the indicators of the EPL index. The April amendments to the Employment Relationships Act and the Labour Market Regulation Act altered the values of 9 of the total 25 indicators, namely: (i) dismissal notification procedure, (ii) delay involved before notice can start, (iii) length of notice period at 9 months of tenure, (iv) length of notice period at 4 years of tenure, (v) severance pay at 20 years of tenure, (vi) definition of unfair dismissal, (vii) possibility of reinstatement following unfair dismissal, (viii) maximum cumulated duration of successive temporary work agency contracts, and (ix) authorisation and reporting requirements for temporary work agencies (see Table P2 in Appendix). This leads to changes in two of the three sub-indices since the regulation of collective dismissals remains unchanged.

Table 8: **Values of the EPL index and sub-indices in 2008 and 2013**

	2008 – previous regulation	2013 – new regulation
1. protection of regular employment	2.98	1.99
2. regulation of temporary employment	2.50	2.13
3. regulation of collective dismissals	2.88	2.88
Total EPL index	2.76	2.19

Source: for previous regulation OECD, for new regulation IMAD.

The value of the EPL index, which is now below the OECD average, shows that the Slovenian labour law legislation can no longer be considered rigid.

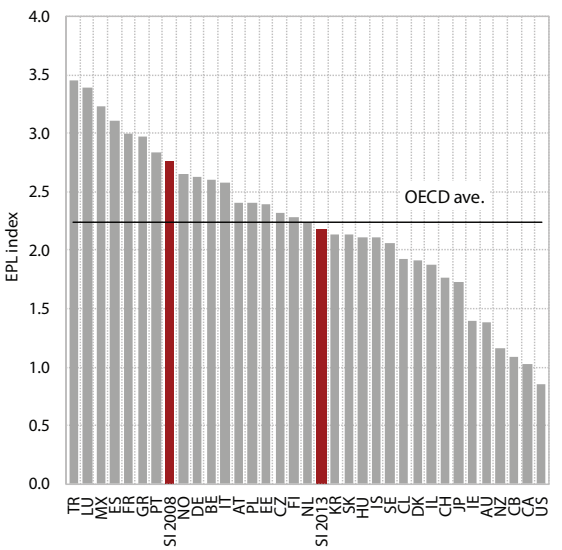
[22] 12 indicators are evaluated: dismissal procedure, notice period and severance payment in case of dismissal of a worker at 9 months, 4 years or 20 years of tenure, difficulty of dismissal, probationary period duration, definition of unjustified dismissal, and possibility of reinstatement upon unjustified dismissal.

[23] Here, the legal regulation of fixed-term employment and the operation of work agencies are assessed, mainly in terms of the number of successive temporary contracts and restrictions to the duration of temporary or fixed-term employment.

[24] These indicators include the definition of collective dismissals, the notification of trade unions and competent public institutions, the required negotiating procedures, dismissal criteria and severance pay amounts.

The recent amendments diminished the rigidity of regulation mainly as regards the protection of regular employment against individual dismissal. The decline of the value of the sub-index protection of regular employment against individual dismissal, falling from 2.98 to 1.99, is particularly important for the adjustment capacity of companies. A lower value is recorded also by the sub-index regulation of temporary forms of employment. Slovenia thus ranks below the OECD average (2.26). Prior to the amendments, Slovenia ranked among the countries with a rather rigid regulation of dismissal of regularly employed workers and – in general – a rigid labour law regulation. Following the amendments, the value of the total index brings Slovenia closer to the Netherlands, Slovakia and Hungary.

Figure 23: **EPL index in OECD countries in 2008 and in Slovenia in 2013**



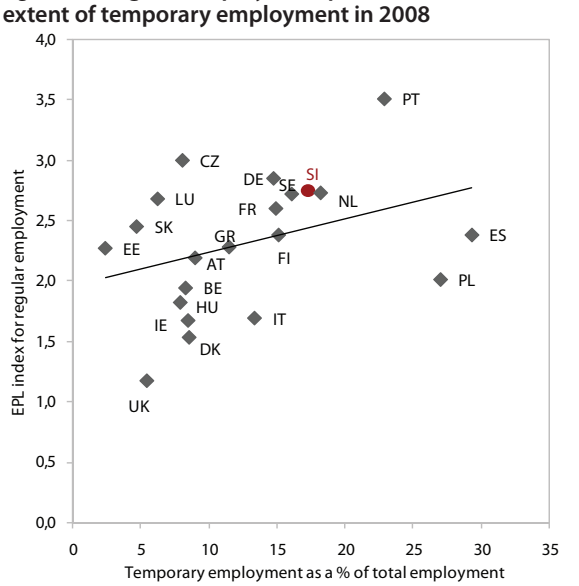
Source: OECD, for Slovenia 2013 IMAD.

Some of this year's changes in the labour market regulation that cannot be evaluated with the EPL index methodology could result in reduced flexibility. Although following this year's amendment, the EPL index points to a considerable decline of rigidity, it needs to be pointed out that the index does not cover all the changes brought about by the new legislation. As regards temporary employment, the EPL index cannot estimate all the expected changes in legal regulation. In fact, there have been changes that might even lower the flexibility of the labour market. Among these, mention needs to be made of the introduction of severance payments in the case of fixed-term contracts, which reduces the difference between fixed-term and permanent employment protection and could have a positive influence on dualism or segmentation. Yet in a time of great uncertainty, such a change might decrease employers' interest in fixed-term employment, thus reducing the already modest employment situation. Likewise, the introduction of quotas in the employment of fixed-term agency workers could represent a restriction to some companies, reducing their flexibility in adjusting to increased, or decreased business opportunities.

With the new regulation, work agencies are no longer required to annually report on their work, which decreased the EPL index, although this means that there is also less of a basis to monitor and control their operations. Within the framework of regulating the operations of temporary work agencies, the mandatory reporting thereof is also being evaluated but, according to our estimate, it has no impact on the ability of companies to adjust. This year's amendment to the Labour Market Regulation Act abolished the obligation of annual reporting. In our opinion, the change did not improve the flexibility of the labour market but rather removed the basis to control the operation of work agencies and monitor the scope of such employment which, with the crisis in Slovenia, more than doubled.

The changed values of sub-indices indicate the possibility of reducing labour market segmentation, yet such an impact could be reduced by other regulations. Strong protection of regular employment generally increases the use of temporary employment and leads to labour market segmentation. Some empirical studies show that the rigidity of the sub-index protection of regular employment intensifies the use of temporary forms of employment. As seen in Figure 24, the countries where regular employment protection is stronger normally record a higher share of

Figure 24: **Regular employment protection index and extent of temporary employment in 2008**



Source: OECD, Eurostat.

Box 2: **Assessment of the labour demand function**

The impact of the adopted changes in labour market regulation, measured by the employment protection legislation (EPL) index, on employment and labour flexibility in Slovenia was assessed by means of the dynamic function of labour demand. The assessed dynamic labour demand function, deriving from Hamermesh's labour-demand model, indicates the capacities and possibilities of employers to rapidly modify employment rates in companies and, in particular, specifies what mostly affects their decisions (labour costs, sales income, capital costs, etc.) and to what extent. To assess the latter, the generalised method of moments (GMM) or the Blundell-Bond estimator was used:

$$\ln EMP_{i,t} = \sum_{j=1}^{n} \alpha_j \ln EMP_{i,t-j} + \sum_{j=1}^{n} \beta_j \ln LCEMP_{i,t-j} + \sum_{j=1}^{n} \gamma_j \ln S_{i,t-j} + \sum_{j=1}^{n} \lambda_j (\ln LCEMP_{i,t-j} \times EPL_{t-j}) +$$
$$\sum_{j=1}^{n} \eta_j (\ln LCEMP_{i,t-j} \times EPL_{t-j} \times Dkriza_t) + \tau Dkriza_t + \sigma EPL_t + u_i + \varepsilon_{i,t},$$
$$i = 1,\ldots, N; t = 1,\ldots, T_i \qquad (y)$$

where i denotes the company and t is the year. EMP represents the average number of employees based on working hours in an accounting period, $LCEMP$ denotes real compensation of employees (gross gross wage), S is real net sales income, $Dkriza$ is a shell variable that since 2008 equals one, and EPL is the employment protection index.

Table 10 presents the estimated dynamic functions of labour demand for the entire economy in the period 1995-2011. Given the verification of the robustness of results, the function is assessed by two different reform indices. For the evaluation of reform measures in the second column, the total EPL index is used; in the third column, only its most important component is used, i.e. regular employment.

Table 10: **Estimates of the dynamic function of labour demand for the economy as a whole; the dependent variable is the logarithm of the number of employees**

	Total EPL index		Protection of regular employment	
	coef.	stand.err.	coef.	stand.err.
EMP(T-1)	0.99*	0.02	0.98*	0.02
EMP(T-2)	-0.12*	0.01	-0.11*	0.01
LCEMP	-0.84*	0.12	-0.46*	0.08
LCEMP(T-1)	0.59*	0.09	0.53*	0.08
LCEMP(T-2)	-0.3*	0.06	-0.21*	0.07
*LCEMP*EPL*	0.18*	0.04	0.02	0.02
*LCEMP*EPL(T-1)*	-0.01*	0.003	-0.003*	0.00
*LCEMP*EPL(T-2)*	0.02*	0.003	0.01*	0.00
*LCEMP*EPL*Dkriza*	-0.02*	0.01	-0.01**	0.006
*LCEMP*EPL*Dkriza(T-1)*	0.002*	0.001	0.002*	0.00
*LCEMP*EPL*Dkriza(T-2)*	-0.05*	0.001	-0.005*	0.00
S	0.47*	0.04	0.50*	0.03
S(T-1)	-0.37*	0.03	-0.39*	0.03
Dkriza	0.12*	0.07	0.15**	0.06
EPL	-0.57*	0.13	-0.07	0.08
	χ^2 Sargan (124) = 152 P=(0.06), M1=-20 M2 = 0.03		χ^2 Sargan(124)=142 P=(0.12,) M1=-19 M2 = 0.73	
Number of units = 95.276 in N = 13.775				

Note: WC-robust two-level estimator. All variables are in logarithms. Robust standard errors. */** denotes statistically significant coefficients at one/five percent risk rate. No constant reported.
Legend: EMP–employment (number of employees based on working hours), LCEMP- labour costs, EPL index, Dkriza-shell variable for crisis, S-sales income, P-probability. Labour costs and sales are deflated by the producer prices index.

Table 9: **EPL index in Slovenia in 1991-2013**

	1991–1992	1993	1994–1997	1998-2003	2003–2007	2008-2012	2013
EPL – total	4.2	4.0	4.1	3.1	2.7	2.8	2.2
(a) protection of regular employment	3.8	3.8	4.0	4.0	2.7	3.0	2.0
(b) regulation of temporary employment	4.4	3.9	3.8	1.3	2.0	2.5	2.1
(c) regulation of collective dismissal	4.7	4.9	5.3	5.3	4.8	2.9	2.9

Source: Vodopivec, M. et al. (2012) until 2012, for 2013 IMAD's estimates.

temporary employment. The changes have, therefore, been evaluated also as to whether they can achieve the aim of reduced segmentation. Considering that the decrease of the sub-index protection of regular employment was more notable than the decrease of the sub-index regulation of temporary employment, it can be established that the differences in the status of workers employed on a fixed-term basis and those in regular employment will decrease, which could lead to reduced labour market segmentation. Segmentation will nevertheless continue to be influenced by student work. Despite the rise in concession fees, student work remains – in terms of price and procedure – appealing and will further hinder the reduction of segmentation. In addition, the new regulation introduces additional competition to employment, i.e. temporary and occasional work of pensioners. It is therefore questionable whether the changes can significantly increase the scope of permanent employment contracts, thus reducing segmentation.

The EPL index was used for a quantitative assessment of the impacts of the changes. Despite its methodological deficiencies, the EPL index represents a synthetic index enabling comparisons of market regulation among countries and time periods. As indicated in Table 9, the EPL index in Slovenia has

Box 3: **Brief overview of the results of the analysis of impacts of employment protection reforms**

To examine the impacts of employment protection legislation (EPL) on the labour market, empirical studies frequently apply the employment protection legislation index. For international comparisons of flexibility of employment protection legislation, the OECD developed the employment protection legislation (EPL) index. The latter quantifies the information regarding the regulation of the labour market and enables simple comparisons of EPL flexibility between the countries.

As a general rule, the flexibility of employment protection legislation intensifies the flows out and into unemployment and decreases the unemployment of vulnerable groups, long-term unemployment, and labour market segmentation. A more flexible EPL allows the companies to employ and dismiss workers more easily. When the companies employ more easily and without higher dismissal costs, the flows out of unemployment will increase. On the other hand, easier dismissals increase flows into unemployment. Empirical studies (e.g. OECD 2004, Bassanini and Duval 2006, EC 2012, Bouis et al. 2012) indicate that the final effect of employment protection reforms on the aggregate level of employment or unemployment is rather unclear, owing to a balance of the flows out and into unemployment. Slightly more consensus is achieved in relation to the impact of reforms on the unemployment of vulnerable groups on the labour market, such as young people and women, since a more flexible EPL diminishes the obstacles to their entry into the labour market, thus reducing the relevant unemployment rates (Bouis et al. 2012). Moreover, a more flexible legislation reduces long-term unemployment – given increased flows out and into unemployment, the unemployed stay in unemployment for a shorter period of time. A less rigid permanent employment protection reduces labour market segmentation by promoting such form of employment and hence reducing the share of temporary employment.

The effects of EPL reforms depend on the economic situation. Although the flows out and into unemployment do not have a significant impact on aggregate employment or unemployment, short-term effects of EPL reforms on unemployment can be either positive or negative, depending on the economic situation at the time of implementation. When a more flexible legislation allows the companies to more easily adjust to various economic conditions, the reforms will – in favourable economic conditions – positively reduce unemployment since the companies employ workers more rapidly and easily. Quite the opposite, in unfavourable economic conditions, the introduction of flexible EPL reforms can lead to an increased transition from employment into unemployment (Bouis et al. 2012).

been decreasing since the country's independence. A first notable decline was recorded in 1998 when the Employment and Insurance against Unemployment Act regulated and allowed the operation of temporary work agencies. The second major decrease was observed this year with the changes in the regulation of temporary employment and reduced regular employment protection. The index served to establish whether the altered employment protection in Slovenia had any repercussion on employment.

In quantitative terms, the effects of this year's changes in the regulation were evaluated based on the labour demand function (see Box 2). The impact of the adopted amendments in labour market regulation, measured by the EPL index, on employment and labour flexibility in Slovenia was assessed by using the dynamic function of labour demand, evaluated based on data obtained from Slovenian companies. The impacts on employment were analysed by means of the total EPL index and its most important sub-index: protection of regular employment. The results of both models are very similar, which confirms the basic results. As can be seen from the estimated function and scores in Table 10, the impact of the adopted changes on employment is non-linear and depends on labour costs. Considering the total EPL index, all coefficients are, from a statistical point of view, significantly different from zero, which however does not hold entirely true in the second model where the total EPL index is replaced with the sub-index of protection of regular employment. By means of classification of labour costs, an attempt has been made to evaluate the entire impact of employment protection on employment, resulting in the conclusion that the total impact is positive but not significant. A similar result is obtained with the evaluation of the basic model (total EPL index), excluding all interactional elements.

The econometric estimates of the labour demand function show that the adopted changes could have positive, although modest repercussions on employment and at the same time improve employment adjustment to changed labour costs. The adopted changes could positively affect the increase of employment elasticity with regard to labour costs; namely, the decline of the index (which implies a more flexible labour market) is related to greater elasticity of employment with regard to labour costs, both on a short and on a long run. In times of crisis, the increase of elasticity is slightly lower. In this regard, it needs to be emphasised that due to the crisis, which coincides with an increase in the EPL index and also has a significant impact on other components of labour demand, particularly a decline in sales, it is very difficult to evaluate the actual impact of employment protection on total employment. Nevertheless, it can be said that the adopted changes, which show in a changed EPL index, could have a positive, although minor impact on employment. The latter is reflected in a greater flexibility of the labour market, which is a good basis for an accelerated increase of employment following a revival of economic growth.

As regards flexicurity, this year's changes somewhat enhance the component of flexibility of contractual relations, but nevertheless depart from the aforementioned concept. The changes adopted this year eventually altered the flexibility of contractual relations. On the other hand, the Fiscal Balance Act decreased the level of compensations (reducing accrual percentages and the maximum amount of compensation), which to our estimates increased incentives to work, but simultaneously reduced the income security of the unemployed. 2012 saw a new decline in the number of persons included in active employment policy programmes, which, however, does not yet play a significant role in the flexicurity concept. In the past year, adult participation in life-long learning, one of the pillars of flexicurity, decreased considerably, with low levels achieved mainly in participation of older and less educated persons.

4. Challenges

Due to deteriorated conditions and growing structural problems on the labour market, developing a set of measures which will be aimed at increasing the scope of labour activity is one of the main challenges of economic policy. In 2008-2012, Slovenia recorded a greater decrease in the employment rate than most other EU countries, which was due to a significant decline in economic activity as a result of structural weaknesses in the Slovenian economy and, partly, the impact of the substantial increase in the minimum wage on the loss of competitiveness. The structural problems on the labour market increased during this period, while Slovenia also ranked among the countries where long-term unemployment increased most notably over the last years. The Slovenian objective under the Europe 2020 strategy to achieve a 75% employment rate by 2020 (of the population aged 20-64) became unattainable, since to attain this target a 1% average annual growth in the period 2013-2020 would be needed. To reverse this trend and to gradually achieve the set objective, Slovenia should develop, as soon as possible, a set of measures aimed at increasing the scope of labour activity and ensuring greater coherence of individual policies that go beyond labour market policies. In addition to further structural reforms, efforts should be concentrated on public finance consolidation, efficient rehabilitation of the banking system and the creation of an environment that fosters entrepreneurship (for details see the Development Report 2013).

Due to the problem of strong labour market segmentation and the need to increase the responsiveness of the labour market to the crisis, it is necessary to design the missing sets of labour market reforms and change certain labour market institutions. Amendments in the field of regular employment protection were aimed at increasing flexibility as they lowered dismissal costs for some categories of workers and simplified the dismissal procedure. Since another objective thereof was to reduce labour market segmentation, also other amendments, which the EPL index does not include, were adopted and might act in the sense of reducing flexibility (e.g. introduction of severance payments for fixed-term employment and quotas for temporary employment of agency workers). The adopted amendments are thus a consequence of pursuing two different primary objectives (increasing flexibility and reducing segmentation) and the compromises reached in negotiations between the social partners. Nevertheless, the amendments were indeed a step in the right direction, since the econometric estimates of effects of the adopted amendments reveal positive, yet modest effects on the employment. However, it is necessary to monitor the effects of changes that were already made in relation to the labour market regulation and make corrections in those areas that could further increase the flexibility of the labour market. Because student work is an important reason for the strong segmentation of the labour market in Slovenia, a different arrangement of student work is another challenge to be met. In this respect, it is necessary to also consider the consequences that the legal regulation of student work might have on the indicators of the labour market situation of young people and for their socio-economic position during education. At the same time, it needs to be highlighted that in order to enhance the responsiveness of the labour market to the crisis situation, also other labour market institutions should be reformed, particularly by increasing the efficiency of active employment policy programmes and the functioning of the Employment Service, as well as by achieving a more responsive wage system.

Due to increasing structural problems on the labour market, another challenge is to enhance active employment policy programmes. With the possibility of integrating workers whose employment is at risk into life-long career counselling, the importance of these schemes in terms of preventing transition to unemployment and thus the need to increase funds for labour market services is growing. In 2011 and 2012, participation of the long-term unemployed, the elderly and people with low education in active employment policy programmes dropped sharply, while a decline was also seen in the participation of the unemployed in training and education programmes. In view of the growing imbalances on the labour market, this is considered to be an inappropriate policy. The challenge, therefore, is the development and expansion of programmes preventing the transition into long-term unemployment and workplace training programmes in cooperation with employers. To reduce structural imbalances it would be reasonable to enhance, in the short term, the implementation of active employment policy programmes in the field of education and training, which need to be more connected to the needs of employers. As a more systematic solution, the system for monitoring and anticipating employers' needs for skills and knowledge should be established. With the enforcement of amendments to the Labour Market Regulation Act abolishing the mandatory notification of a job vacancy to the Employment Service, the basis for the system of monitoring demand by occupational groups was lost, otherwise representing an important source of information on employment opportunities for students deciding on further education, and information useful

in the conduct of education policy and development of active employment policy programmes.

The significant deterioration of the labour market situation of young people during the crisis calls for measures aimed at improving the employment opportunities for the young. Slovenia is one of the countries where the youth unemployment rate increased the most during the crisis. The inconsistent structure of tertiary education graduates by field of education with labour market demands and the considerable increase in the number of graduated in 2008-2011 escalated the problems of young graduates in transition from education to employment. These inconsistencies also exist at the levels of secondary and vocational education. Due to ageing of the population and investment in education, it is necessary to prevent the brain drain and use the knowledge and skills of young people. Since the young became the first priority in the European employment policy, Youth Guarantee schemes were developed at the EU level, which provide funding to formulate programmes tackling youth unemployment.[25] Special schemes intended for young people are already implemented in some countries, while in Slovenia innovative and efficient schemes along with employment guarantees for young people should be developed and implemented as soon as possible with the support of the available European funds. For several years now, the analyses of youth unemployment have been calling attention to the inconsistency of the education programme network at the levels of secondary and tertiary education with labour market demands. The enrolment of young people in vocational and secondary programmes which are in high demand on the labour market is declining, while participation in tertiary education rose significantly, but young people have thus postponed rather than improved their entry into the labour market. The latter represents the key problem of Slovenia's education system, for which common solutions should be sought by education and employment policy-makers and social partners, particularly employers. Only with the participation of employers in the preparation and implementation of education programmes we will be able to ensure a quality and professional education for the youth, as well as their transition to employment through traineeship and similar schemes of practical career training.

To improve the responsiveness of wages to a crisis situation, it would be sensible to also consider a change in the wage bargaining system. Following the decline in economic activity, the adjustment to the changed conditions was less pronounced in wages than in employment. The smaller adjustment was largely due to the rise in the minimum wage, as well as to the wage determination mechanism (mostly at sectoral level). Economic theory states that wage bargaining at sectoral level generally provides fewer opportunities for wage adjustment than company-level bargaining. Various studies[26] show that wage formation (and hence the movement of wages) in Slovenia is crucially dependent on bargaining at the level of sectors, meaning that wages are settled by sectoral collective agreements. Therefore, another challenge is to ensure greater wage responsiveness through collective agreements at company level. It would also be worthwhile to examine the system for determining the minimum wage. With one of the most significant drops in economic activity in the EU, Slovenia recorded the greatest increase in the minimum wage, by almost 30% in real terms over the period 2008-2012. In the circumstances of a considerable decline in economic activity, decrease in employment, wage stagnation in the private sector and wage reduction in the public sector, coupled with uncertainty about the future, it would be sensible to consider a legal possibility of a smaller increase or non-adjustment of the minimum wage, as seen in some parts of the EU. In the public sector, however, the manner of adjusting the wage bill to the objectives of fiscal consolidation is becoming increasingly problematic. In fact, the measures prevailing over the last years do not allow for a stimulating policy of rewarding employees. From this aspect, formulating measures in the field of wages and making changes to the wage system that would offer more incentives and would not lead to a levelling of wages seems to be another challenge amid continued fiscal consolidation.

[25] At the end of February 2013, all EU Member States committed themselves to offer every young person under the age of 25 a quality offer of employment, enrolment in continued education, apprenticeship or traineeship within 4 months after the completion of their education or beginning of unemployment.

[26] Analyses and surveys in the framework of the ECB Wage dynamic network project.

Appendix

Table P1: **Notice periods and severance payments in weeks for workers at three lengths of service in selected OECD countries in 2008**

Country		Notice period 1) for length of service			Severance pay 2) for length of service		
		9 months	4 years	20 years	9 months	4 years	20 years
Austria	Blue collar	2	2	2	0	0	0
	White collar	6	8	16	0	0	0
Belgium	Blue collar	5	5	16	0	0	0
	White collar	12	12	60	0	0	0
Czech Republic	All workers	8	8	8	0	0	0
	Redundancy cases				12	12	12
Denmark	Blue collar	3	8	10	0	0	0
	White collar	12	16	24	0	0	12
Estonia	Liquidation of firm	8	8	8	8	8	16
	Redundancy	8	8	16	8	8	16
	Unsuitability	4	4	4	4	4	4
Finland	All workers	2	4	24	0	0	0
France	All workers	4	8	8	0	3.2	26.8
Greece	Blue collar	0	0	0	0.7	2.14	16
	White collar	4	12	64	2.14	6	32
Ireland	All workers	1	2	8	0	0	0
	Redundancy cases	2	2	8	0	3.6	16.4
Italy	Blue collar	0.86	1.29	1.7	0	0	0
	White collar	2.1	8	16			
Luxemburg	All workers	8	8	24	0	0	24
Hungary	All workers	4	5	12.8	0	4	20
Germany	Personal reasons	4	4	28	0	0	0
	Operational reasons				1.6	8	40
Netherlands	Termination via PES	4	4	12	0	0	0
	Termination via court	0	0	0	0	24	72
Norway	All workers	4	4	12	0	0	0
Poland	All workers	4	12	12	0	0	0
Portugal	All workers	2.1	4.2	10.7	12	16	80
Slovakia	All workers	8	8	12	8	8	12
Slovenia	Business reasons	4	4	10.7	0	3.2	46.9
	Fault-based reasons	4	4	8.5			
Slovenia (new Employment Relationships Act)	Business reasons	2	5.1	8.5	0	3.2	35
Spain	All workers	4	4	4	2.8	14	68
Sweden	All workers	4	12	24	0	0	0
Switzerland	All workers	4	8	12	0	0	10
United Kingdom	All workers	1	4	12	0	0	0
	Redundancy cases				0	4	20

Source: OECD detailed description of employment protection in OECD and selected countries
Notes: 1- notice periods in weeks, 2- severance payments in number of weekly wages

Table P2: **Detailed indicators of the EPL index**

	Indicator	2008-previous regulations	2013-new regulations
REG1	Notification procedures	6	4
REG2	Delay involved before notice can start	2	1
REG3A	Length of notice period at 9 months of tenure	3	2
REG3B	Length of notice period at 4 years of tenure	3	2
REG3C	Length of notice period at 20 years of tenure	1	1
REG4A	Severance pay at 9 months of tenure	0	0
REG4B	Severance pay at 4 years of tenure	2	2
REG4C	Severance pay at 20 years of tenure	3	2
REG5	Definition of unfair dismissal	4	2
REG6	Length of trial period	3	3
REG7	Compensation following unjustified dismissal	3	2
REG8	Possibility of reinstatement following unjustified dismissal	4	4
REG9	Maximum time to make a claim of unfair dismissal	1	1
FTC1	Valid causes for use of fixed-term contracts	2	2
FTC2	Maximum number of successive fixed-term contracts	0	0
FTC3	Maximum cumulated duration of successive fixed-term contracts	2	3
TWA1	Types of work for which temporary work agency employment is legal	1.5	2
TWA2	Restrictions on number of renewals of temporary work agency contracts	2	2
TWA3	Maximum cumulated duration of successive temporary work agency contracts	4	2
TWA4	Authorisation and reporting requirements for temporary work agencies	6	2
TWA5	Regulations requiring equal treatment of regular and agency workers at the user firm	6	6
CD1	Definition of collective dismissal	4.5	5
CD2	Additional notification requirements for collective dismissals	3	3
CD3	Additional delays involved before notice can start for collective dismissals	1	1
CD4	Other special costs to employers of collective dismissals	3	3

Source: for previous regulation OECD, for new regulation IMAD.

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Employment and Insurance against Unemployment Act

Employment Relationships Act

Labour Market Regulation Act

Fiscal Balance Act

Act Amending the Labour Market Regulation Act

III.
Impact of the Economic Crisis on the Credit Market in Slovenia

Summary

The situation on the credit markets is deteriorating for the fifth consecutive year. The banks' lending activity has been declining, not only as a result of a significant decline in loan supply, but also as a result of much more modest loan demand. There was a decline in household borrowing in 2012, the first since the outbreak of the crisis, and much stronger corporate and NFI deleveraging. By contrast, the stock of government loans continued to increase, given the limited access to international financial markets. According to our estimate, the government was mainly financed by state-owned banks. The financial crisis has had an above-average impact on the Slovenian economy, as Slovenian firms are relatively more dependent on bank loans than their counterparts abroad. The strict constraints on access to the main source of finance is one of the main reasons why economic activity in Slovenia is among the lowest in the euro area.

The modest supply of loans from Slovenian banks is thus a result of highly limited funding for banks as a result of the adverse situation both in the Slovenian banking system and on international financial markets. The ongoing deterioration in the Slovenian banking system shook foreign investors' confidence in Slovenian banks, which have therefore faced an outflow of foreign funding ever since the outbreak of the crisis. The liquidity pressure on the banks has increased substantially in recent years. In the past the banks managed to partly replace foreign funding with borrowing at the ECB and with government and household deposits, but domestic funding also started to gradually dry up. In 2012 the availability of domestic funding declined further, as the government had fairly limited access to international financial markets for most of the year; moreover, the stock of household deposits also started to fall, given the deterioration in the labour market and the adverse situation in the Slovenian banking system overall. The latter is particularly worrisome, as households have proved to be one of the most reliable sources of funding for the Slovenian banking system ever since the outbreak of the financial crisis. With the deterioration in the situation in response to the developments in Cyprus, this type of pressure on liquidity in the Slovenian banking system intensified.

However, many of the problems in the Slovenian banking system are the result of internal factors unrelated to the international financial markets. The banks having financed a number of economically unviable projects in the years before the crisis, the quality of bank assets has deteriorated sharply in recent years. By the end of 2012 bad loans had climbed almost to EUR 7 bn and accounted for around 15% of the banks' total exposure. The banks therefore had to create additional provisions and impairments, which brought a significant deterioration in their performance. The increase in bad claims reduced the capital adequacy of the Slovenian banking system, which is one of the least capitalised banking systems in the euro area; furthermore, stress test results show the Slovenian banking system to be highly vulnerable to economic shocks.

The capital adequacy of the banking system has not increased significantly despite several recapitalisations during the crisis. The banks have been recapitalised only to the minimum amount of capital required by the regulator, and were therefore not able to take up new risks, despite the capital increases. Consequently, the share of bank customers with the highest credit ratings declined significantly, which in turn increased the proportion of bad assets in the Slovenian banking system. The corporate governance of banks has not been improved during the crisis, which is another factor in the adverse situation in the Slovenian banking sector.

On the side of loan demand, the most important limiting factor is corporate and NFI indebtedness. This is also one of the main factors in the modest economic activity. The financial structure of Slovenian firms is fairly unfavourable. They are overly dependent on short-term financing (such as loans and trade credits), which account for an above-average share, while the share of longer-term financing (equity and long-term debt securities) is quite modest. In the period of credit expansion, corporate and NFI indebtedness as measured by the debt-to-equity ratio did not increase significantly, which was a consequence of a rapid increase in equity due to the favourable developments on the Slovenian capital market. Indebtedness only soared in 2008, as a result of a noticeable decline in equity, as lending activity was already gradually slowing. Despite the pronounced repayments of bank loans in recent years, indebtedness was not reduced substantially, which can be explained by the much lower capitalisation at non-financial corporations and NFIs. Non-financial corporations with high leverage have highly limited access to fresh sources of financing.

The modest economic activity in Slovenia is another increasingly important factor in the limited demand for loans. Owing to a decline in output, capacity utilisation is modest. There is practically no demand for investment, which is keeping corporate demand for investment loans low; demand for loans for working capital is also subdued. As a result of financial difficulties, firms are mainly seeking loans for debt restructuring.

The strong dependence of the Slovenian economy on bank financing and the high level of state ownership of Slovenian banks have resulted in significant risk migration between the banking system and public finances. The situation in the Slovenian banking system, coupled with insufficient structural reforms, is one of the main factors in Slovenia's sovereign downgradings, which are making it even more difficult to obtain bank funding. This has translated into an even larger contraction in lending activity and, in turn, economic activity, which on one hand is reducing general government revenue, and on the other is increasing general government expenditure. Meanwhile, the share of bad claims continues to increase, which is leading to an additional deterioration in the banking system. Given the high level of state ownership of the banking system and the delays in restructuring the banks, the government also has to cope with increasing expenditure related to bank recapitalisation.

Restructuring the banking system and reducing state ownership are vital prerequisites for the recovery of the Slovenian economy. The end of 2012 therefore saw the adoption of the Act Determining the Measures of the Republic of Slovenia to Strengthen Bank Stability, which envisages a capital increase in the Slovenian banking system and the transfer of bad claims to the Bank Assets Management Company (BAMC). It is assessed that this should contain risk migration between the banking system and public finances, and provide for conditions conducive to economic recovery, while the withdrawal of the government from the corporate sector should contribute towards better corporate governance. Given the adverse financial structure of the Slovenian economy, it would also be sensible to encourage those segments of financial services that provide long-term financing.

Introduction

Because of the poorly developed non-banking segments of the financial system, the Slovenian economy exhibits above-average dependence on debt financing (banks in particular), which, given the bad shape of the Slovenian banking system, is additionally stifling economic activity. This is one of the reasons for the above-average contraction in economic activity compared with other euro area countries. The heavy reliance on short-term financing during a time of adverse developments on the financial markets is putting additional liquidity pressure on the economy. Firms are thus compelled to devote more time and energy to handling their financial difficulties, instead of focusing on their core business.

This section of Economic Issues focuses primarily on developments related to the financing of the Slovenian economy.[1] The first chapter deals with credit market trends in the euro area and Slovenia. The second provides more detailed analysis of the reasons for low lending activity, while the third focuses on the financial structure of non-financial corporations and NFIs. The fourth chapter presents an assessment of risk migration between the public finances and the banking system, while the final section addresses future challenges.

[1] The analysis includes data released up to and including 17 May 2013.

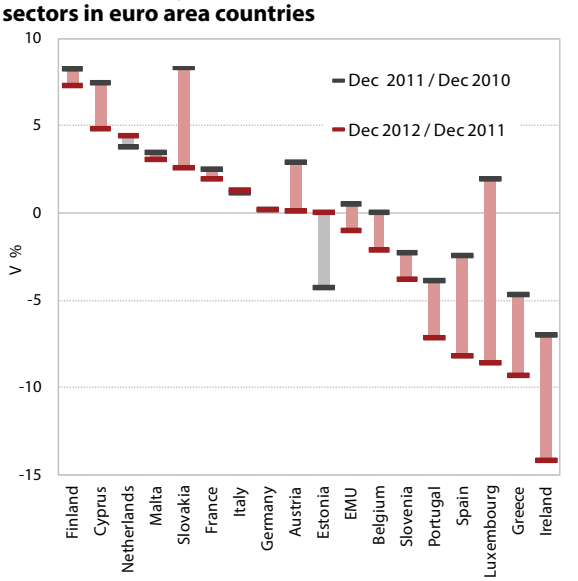
1. Credit markets

After a break in 2010 and 2011, the situation on the credit markets in the euro area deteriorated again in 2012, while the credit market situation in Slovenia has been deteriorating continually since 2009. The stock of household loans alone was up in the euro area, although household borrowing also eased significantly. By contrast, debt repayments by non-financial corporations and NFIs were the highest since the outbreak of the international financial crisis. In Slovenia the banks largely financed the least-risky government-related business entities, while other business entities were primarily repaying debt at Slovenian banks. This was a consequence of both the adverse situation in the Slovenian banking system, which is no longer able to take up new risks due to its low capital adequacy and inability to obtain fresh funding, and the over-indebtedness of the Slovenian corporate sector and the adverse economic situation overall. The constraints on debt financing, which used to be the basis for financing the Slovenian economy in the past, are thus one of the main reasons why Slovenia's economic performance has been among the worst in the euro area in recent years.

1.1 Credit markets in the euro area

In most euro area countries lending activity continued to slow in 2012. Slovenia is once again ranked among the euro area countries with above-average declines in loans to domestic non-banking

Figure 1: **Year-on-year growth in loans to non-banking sectors in euro area countries**



Sources: ECB, Bank of Slovenia; calculations by IMAD.

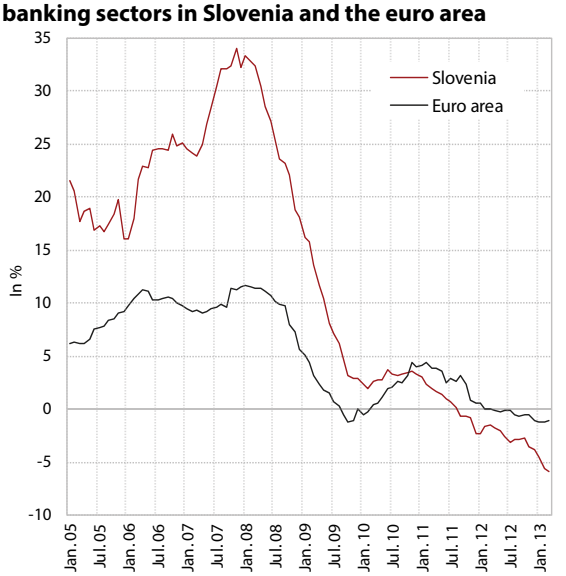
sectors. Only the PIIGS countries (other than Italy), which were hardest hit by the crisis, and Luxembourg recorded larger declines than Slovenia.

In 2012 the stock of loans to domestic non-banking sectors in the euro area declined for the first time since the outbreak of the international financial crisis. The decline of 1% (just over EUR 125 bn) was almost entirely the result of a significant fall in the stock of loans in the final month of the year. At the end of November the stock of loans to non-banking sectors was still slightly larger than at the end of 2011, but credit activity in the euro area had been slowing for most of the year. The decline in the stock of loans was mainly attributable to a drop in loans to non-financial corporations and NFIs. Government loans also declined, albeit by less than in 2011. Household borrowing continued to increase. Households were still mainly raising housing loans, while they made repayments of consumer loans and loans for other purposes.

1.2 Credit market developments in Slovenia

In 2012 loans to domestic non-banking sectors fell for the second consecutive year. At EUR 1.3 bn, the decline was more than 60% larger than in 2011. At this time households were also making debt repayments, while the government sector was, by contrast, strengthening its borrowing. Growth in loans to non-banking sectors has been negative since the second half of 2011 and has continued to gradually decline, being around 4 or 5 percentage points less than euro area average in recent months.

Figure 2: **Year-on-year growth in bank loans to non-banking sectors in Slovenia and the euro area**



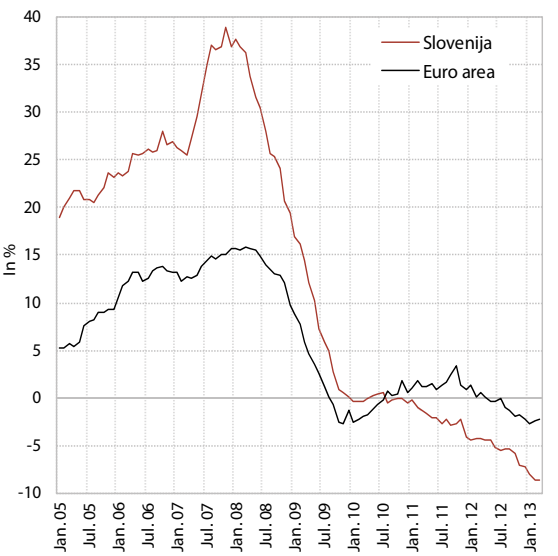
Sources: ECB, Bank of Slovenia; calculations by IMAD.

In the first quarter of 2013 domestic non-banking sectors continued to repay their debts. The stock of loans declined by around EUR 450 m, one of the largest declines to date; only in the final quarters of 2011 and 2012 were larger declines recorded. Nearly three quarters of the decline was attributable to further corporate and NFI deleveraging; the rest was due to debt repayments by households, while the decline in government loans was negligible.

1.2.1 Borrowing by non-financial corporations and NFIs

The decline in loans to non-financial corporations and NFIs strengthened in 2012, to EUR 1.6 bn. Roughly 90% of the decline (double the figure recorded in 2011) was the result of a fall in loans to non-financial corporations, while loans to NFIs declined by approximately a third less than in the previous year. As in previous years, corporate and NFI deleveraging was again largest in December (close to EUR 600 m), which is thought to be a consequence of the large share of loans falling due at the end of the calendar year while they cannot be refinanced by the banks as a result of the adverse situation; Slovenian firms therefore tend to be under the most severe liquidity pressure at the end of the year.

Figure 3: **Year-on-year growth in bank loans to non-financial corporations and NFIs in Slovenia and the euro area**



Sources: ECB, Bank of Slovenia; calculations by IMAD.

In 2012 non-financial corporations and NFIs repaid loans raised abroad, but the net repayments were

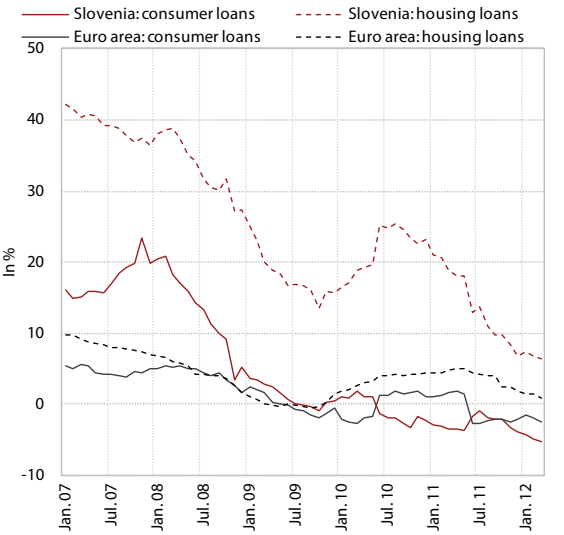
much lower than those to domestic banks.[2] They amounted close to EUR 50 m and were entirely the result of net repayments of short-term loans, while long-term loans still recorded a net inflow of EUR 30 m, which is actually up slightly on the previous year. The smaller contraction in loans than in Slovenia was attributable both to the better state of banking systems abroad, and to the superior financial position of firms raising foreign loans. This type of financing is only used by financially stable firms. By borrowing abroad they also take advantage of the more favourable financing conditions, as foreign interest rates are still lower on average than domestic rates. Borrowing by non-financial corporations and NFIs abroad increased substantially in the first quarter this year. Net inflows amounted to around EUR 580 m,[3] 90% of which was long-term net borrowing.

1.2.2 Household borrowing at domestic banks

In 2012 the stock of household loans declined for the first time since the outbreak of the international financial crisis. Households increased their repayments of consumer loans, while repayments of loans for other purposes remained almost unchanged relative to 2011; household borrowing in the form of housing loans also fell significantly. Household repayments of foreign currency loans rose slightly again in 2012, while the stock of loans in domestic currency declined for the first time since the outbreak of the crisis, by EUR 40 m.

The year-on-year decline in the stock of consumer loans seen since mid-2010 intensified in 2012. It totalled EUR 240 m (2011: EUR 111 m). The decline in consumer loans is consistent with the fall in household final consumption expenditure and the uncertainty in household confidence, which mean that households are reducing consumption of both durables and non-durables. Consumption of durables in 2012 was down fully 5.1% in year-on-year terms, while consumption of non-durables declined by 5.0%. It is estimated that when buying non-durables, consumers are increasingly turning to lower-price brands. As a result of weak consumption, consumer loans have also continued to decline in the euro area. They were down 3.9% in year-on-year terms at the end of 2012, and by as much as 4.2% in March 2013.

Figure 4: **Year-on-year growth in household loans in Slovenia and the EU**



Sources: ECB, Bank of Slovenia; calculations by IMAD.

In 2012 growth in housing loans slowed markedly to its lowest figure to date. The stock of housing loans rose by 1.8% (EUR 95.3 m), almost 5 percentage points less than in 2011. The proportion accounted for by housing loans in Slovenia has thus increased substantially in recent years, but was still 16 percentage points lower than in the euro area overall (73%) at the end of 2012. Having been at a slightly higher level (around 4%) in 2010 and the first three quarters of 2011, growth in housing loans in the euro area began to fall last year, and was fairly modest (at 1.2%).

Although the euro stabilised against the Swiss franc last year, foreign currency lending to households continues to decline rapidly due to persistent uncertainty related to exchange rate movements and unfavourable borrowing conditions. In 2012 it fell almost by EUR 150 m (12.6%). The bulk of the decline (nearly three quarters) was attributable to a fall in housing loans (down by a tenth) and, to a lesser extent, consumer loans, which fell by almost 30%. In just over four years the proportion of lending accounted for by foreign currency loans declined by 7.5 percentage points to 11%.

The stock of household loans dropped further in the first quarter of 2013. The decline amounted to EUR 107 m, 2.6 times more than in the same period of 2012. The largest contribution to the decline

[2] According to Bank of Slovenia figures, the stock of corporate loans declined by 0.5% at foreign banks and by 7.3% at domestic banks.

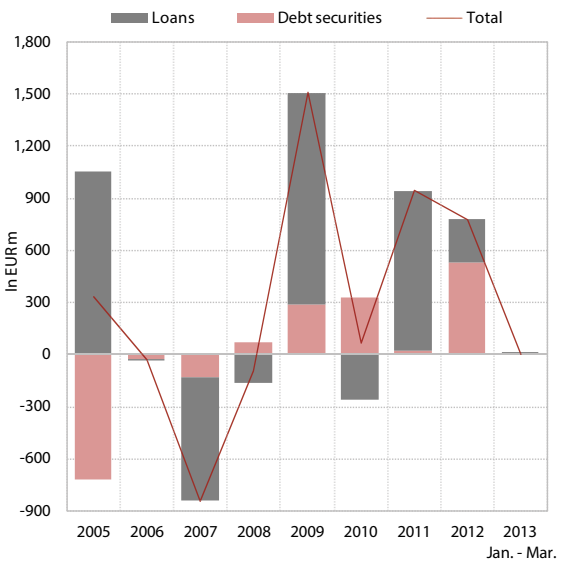
[3] This is a consequence of high net borrowing in March, which amounted to fully EUR 545.1 m; most of this amount (EUR 440 m) was raised abroad by one of the energy companies. Borrowing by non-financial corporations and NFIs abroad this year would also be relatively high even without this one-off event, showing that creditworthy firms are increasingly raising foreign loans, even though lending activity in the EU is also relatively modest. This means that the best clients are leaving the Slovenian banking system.

came from ongoing repayments of consumer loans, although housing loans also shrank at the quarterly level for the first time since comparable figures have been available.

1.2.3 Government borrowing at domestic banks

After easing in 2010, government borrowing at domestic banks intensified again. The main lenders were state-owned banks, given that the government sector had fairly limited access to other financing. The banks' claims against the government sector[4] increased by around EUR 770 m in 2012, almost a fifth less than in 2011. This time the government mainly obtained funds by raising loans, and to a lesser extent by issuing debt securities at domestic banks.

Figure 5: **Estimated increase in the Slovenian banking system's claims against the government**



Sources: Bank of Slovenia; calculations by IMAD.

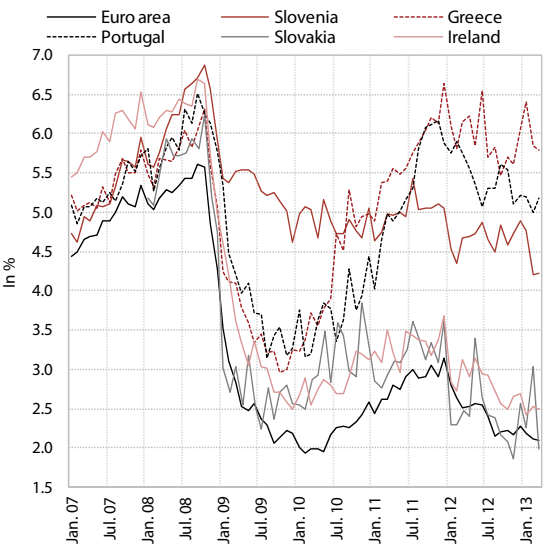
The first quarter of 2013 saw a significant easing in government borrowing from domestic banks. The stock of government loans was down less than EUR 10 m, while the stock of securities rose by the same amount. The government otherwise borrowed around EUR 400 m by issuing short-term securities in the first quarter of 2013, but as the proceeds were used to repay maturing securities, bank exposure to the government did not increase according to our estimates.

[4] Includes government loans and debt securities of domestic non-monetary sectors, most of which are thought to comprise Slovenian government debt securities.

1.3 Interest rates

The spread between domestic and foreign interest rates began to widen again in 2012. This is putting further pressure on over-leveraged firms and is weakening the competitiveness of the entire Slovenian economy. Only in Greece, Cyprus and Portugal are interest rates on corporate loans over EUR 1 m higher. By contrast, interest rates are for example lower in Italy and Spain, which have lower credit ratings than Slovenia, but also have lower interest rates on corporate loans and lower yields to maturity on government bonds. In recent years active interest rates in Slovenia have been much less subject to external factors than in the past.

Figure 6: **Interest rates on corporate loans in Slovenia and selected euro area countries**

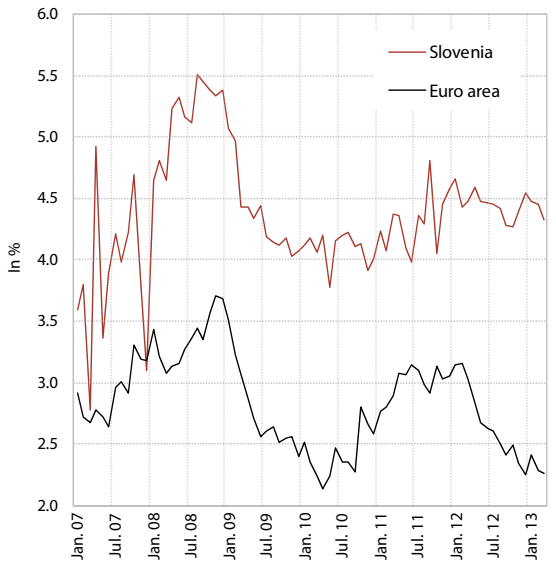


Sources: Bank of Slovenia, ECB.

The spreads in interest rates on long-term deposits also widened slightly last year. This was primarily the result of a decline in deposit interest rates in the euro area, which followed the decline in interbank interest rates more closely than interest rates in Slovenia. Given the increasingly limited access to long-term funding on the international financial markets, the banks are trying to compensate for the loss of foreign funding with domestic long-term funding, which has proved more stable in times of crisis. Interest rates on these deposits are therefore still significantly above the euro area average. The banks are focusing in particular on deposits with maturities of over two years, where the spreads are widest: having exceeded 200 basis points at the end of the year, they are now fluctuating around the highest levels seen in the period of the crisis. However Slovenian

banks continue to offer lower interest rates on short-term deposits to encourage a switch from short-term deposits to long-term deposits.

Figure 7: **Interest rates on long-term deposits of more than two years in Slovenia and the euro area**



Sources: Bank of Slovenia, ECB.

2. Risks to lending activity

There remain risks to lending activity in the Slovenian banking system on both the supply side and the demand side. The banks are limited by the low availability of funding. At the same time, the quality of their assets is continuing to deteriorate. They are therefore creating significant additional impairments and provisions, which is exerting additional pressure to reduce lending activity High-quality demand for loans also remains low as a result of sluggish economic activity and the over-indebtedness of the Slovenian economy.

2.1 Limiting factors on the supply side

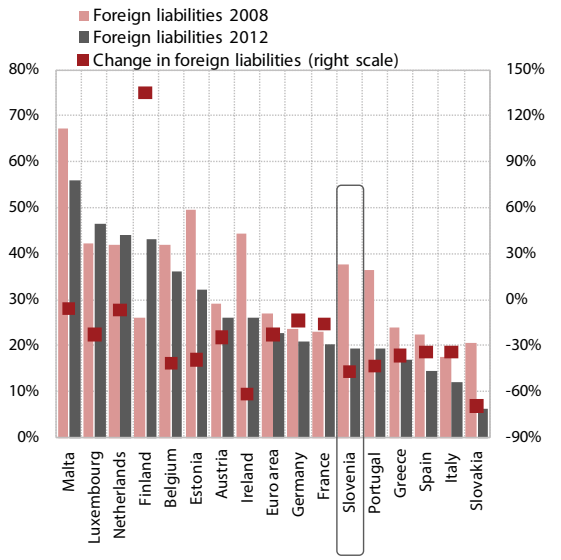
Limitations on the supply side are also a major factor in low lending activity, and are having a highly negative impact on economic activity. The limited supply is hindering access to financing even for firms that are not over-indebted and that have business opportunities despite the crisis, but cannot fully exploit them because of the low availability of financing. Their business activity is therefore lower than it might otherwise have been, which is making the situation in the Slovenian economy even more difficult.

2.1.1 Dependency of banks on foreign funding and availability of foreign funding

After Slovenia joined the EU and the euro area, the dependency of the Slovenian banking system on foreign funding increased significantly. The most important source of funding for the strengthened economic activity was borrowing at domestic banks. However, because domestic funding did not suffice to cover the borrowing requirement, and with foreign funding becoming much more available because of Slovenia's accession to the EU and the euro area, the main source of funding for Slovenian banks' lending activity was the international interbank markets.

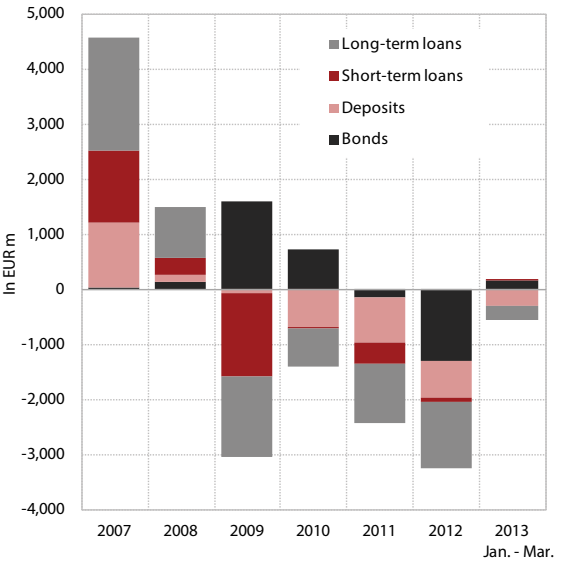
In recent years Slovenian banks have become much less dependent on foreign funding. At the end of 2012 the proportion of the banks' total liabilities accounted for by foreign funding was, as in most of the other exposed countries, below the euro area average. The stock of foreign funding recorded an above-average fall, which is estimated to be attributable to reduced investor confidence in Slovenian banks. The only

Figure 8: **Foreign liabilities as a share of the banks' total assets in Slovenia and the euro area, and change in the stock of foreign liabilities, September 2008 to December 2012**



Sources: World Bank, ECB, Bank of Slovenia; calculations by IMAD.

Figure 9: **Net flows of foreign funding in the Slovenian banking system between 2007 and the first quarter of 2013**



Sources: Bank of Slovenia; calculations by IMAD.

larger declines in foreign liabilities in the euro area were recorded by the banking systems of Slovakia and Ireland, where liabilities to foreign banks declined by 70% and 60% respectively. Between October 2008 and the end of 2012, the banks' foreign liabilities almost halved (down EUR 9 bn), while the proportion of the banks' total liabilities that they account for declined by 20 percentage points to 15.7%.

In 2012 Slovenian banks made net repayments of liabilities to foreign banks in the amount of EUR 3.3 bn. The net repayments were the highest to date, exceeding those in 2011 by nearly 30%. The banks made net repayments of both loans and deposits in 2012. In addition, a significant portion of government-guaranteed bonds also matured in 2012. In 2013 liquidity pressures related to maturing foreign liabilities will ease slightly, but they will remain significant. More than two thirds of all maturing liabilities will be at the banks under majority foreign ownership, which are largely thought capable of refinancing. According to Bank of Slovenia figures, pressures are expected to build more strongly again in 2015, when 25.9% of all foreign liabilities fall due. The pressure on domestic banks will then increase significantly again, and with the ECB's three-year refinancing operations maturing at the same time, it will be even stronger than in 2012.

In the first quarter of 2013 Slovenian banks continued to make debt repayments abroad, but to a lesser extent than in 2012. The banks made net repayments of maturing liabilities of almost EUR 400 million in this period, less than 40% of the amount repaid in the same period of 2012. The banks' repayments of foreign bank deposits remained around EUR 320 m, while net repayments of loans (EUR 230 m) declined by just over a third. Short-term loans recorded a modest net inflow (of around EUR 10 m), while government-guaranteed bonds issued by one of the Slovenian banks in March posted an inflow of approximately EUR 160 m.

2.1.2 Access to domestic funding

Liquidity pressures on Slovenian banks were mitigated slightly by the ECB alone, which strongly supported banks in Slovenia via LTROs. In 2012 alone Slovenian banks' liabilities to the ECB rose by around EUR 2.2 bn, the highest increase since the crisis intensified. In the two LTROs Slovenian banks borrowed around EUR 3 bn in long-term funding, which is 0.3% of the total stock of LTROs, double the proportion of the euro area banking system accounted for by Slovenian banks.

Household deposits fell for the first time since comparable figures have been available.[5] The stock declined by approximately EUR 45 m, in contrast to 2011 when it rose by almost EUR 260 m. The decline in short-term deposits slowed significantly, but there

[5] Since 2005.

was a notable decline in inflows of overnight deposits, and in particular, long-term deposits, which were up EUR 34.2 m, not even a tenth of the increase in 2011. It is felt that this development reflects a further deterioration in the labour market and in the financial system, and the more restrictive social transfer policy.

While in the early part of the financial crisis the government provided liquidity support to the banking system via borrowing, in 2012 government deposits declined. In light of the growing risks related to the public finance position and the situation in the banking system, the ability of the government to obtain international financing had already deteriorated significantly by the end of 2011. The government merely places the obtained funds in short-term deposits, using them primarily to cover its own liquidity needs. In 2012 government deposits at banks declined by approximately EUR 290 m. The overall decline was attributable to a fall in long-term deposits (by around EUR 450 m), which in turn brought a deterioration in the maturity structure of deposits in the Slovenian banking system.

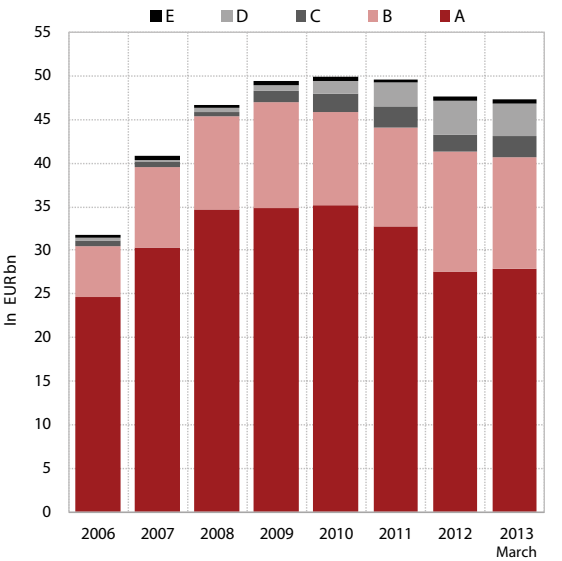
In the first quarter of 2013 domestic funding remained fairly limited. Government deposits increased the most, by over EUR 50 m, primarily as a result of February's transfer of funds from the account at the Bank of Slovenia to accounts at commercial banks. Household deposits merely rose by approximately EUR 35 m, which is the smallest first-quarter increase to date. The stock of household deposits declined more visibly after the deterioration in the situation on the international financial markets in the second half of March. The banks' liabilities to the Eurosystem fell by roughly EUR 35 m.

2.1.3 Further deterioration in the quality of bank investments

Last year the quality of banks' assets deteriorated by nearly a quarter less than in 2011. This was mainly attributable to a much smaller decline in the quality of claims against non-residents (which saw major downgradings from C to D), while the deterioration in the quality of claims against domestic entities was practically the same as a year earlier (EUR 1.1 bn). The total amount of bad claims rose by EUR 1.2 bn and was more than a fifth higher than in the same period in the previous year. In 2012 the share of bad claims[6] rose almost by 3 percentage points, reaching as much as 14.0% of the banking sector's total claims. The increase was also increasingly the result of a decline in the highest-quality claims with a rating of A. This

[6] In this case bad claims means claims rated C, D or E.

Figure 10: **Stock of claims by individual rating between 2006 and 2013**



Sources: Bank of Slovenia; calculations by IMAD.

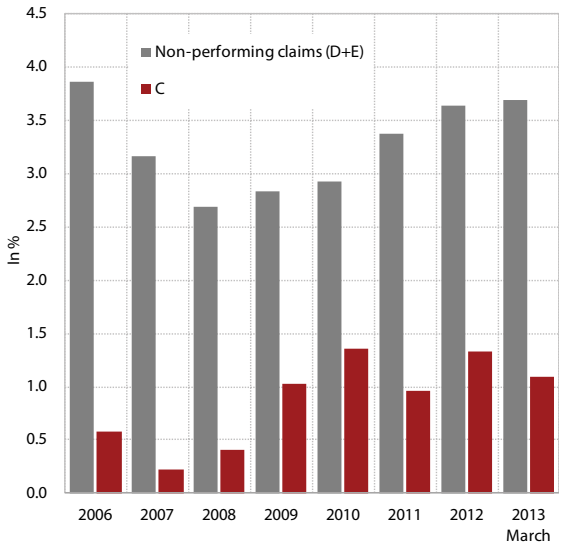
was due to current repayments of maturing liabilities and, partly, the deteriorating quality of these claims. To a great extent, this was also the result of the adverse situation in the Slovenian banking system, as the banks are not even able to grant loans to clients whose credit ratings are good. Last year the stock of A-rated claims fell by EUR 5.1 bn, twice as much as a year earlier, and was down almost EUR 9.3 bn on the peak in the middle of 2009.

Nearly 80% of the total increase in bad claims was the result of the deterioration in the quality of claims against the sectors of construction, financial services, manufacturing, and wholesale and retail trade. Only construction recorded a smaller increase in the stock of bad claims than in 2011 (down 63.3%), while in other aforementioned sectors the increase in bad claims was at least double that in 2011, an indication of the rapid deterioration in sectors that to date have been less exposed. Almost two thirds of the total increase in bad claims against manufacturing (EUR 220 m) was due to a rise in bad claims against industries of higher technology intensity.[7] At the end of 2012 the total stock of bad claims amounted to EUR 6.7 bn, nearly two-thirds of which comprised non-performing claims (D and E), the stock of C-rated claims having declined slightly in 2012.

The quality of claims against households continues to deteriorate, but the increases in bad claims

[7] Chemical industry, manufacture of computer, electronic and optical products, manufacture of electrical equipment and manufacture of transport equipment.

Figure 11: **Share of non-performing and C-rated claims against households, in %, 2006–2013**



Source: Bank of Slovenia.

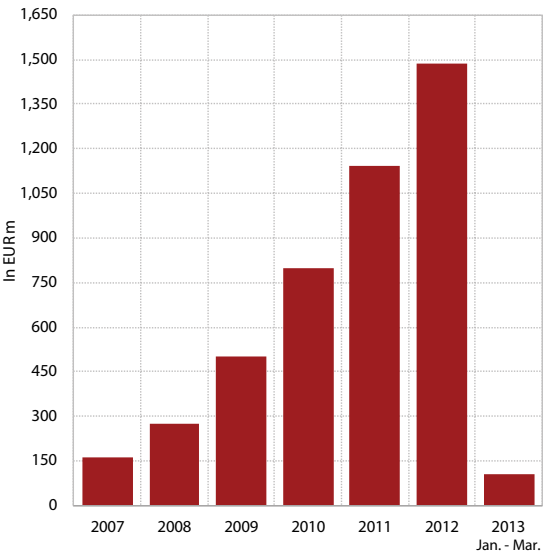
are much smaller than those in claims against corporates. According to our estimate, this is a consequence of low household indebtedness and the more cautious households lending policy pursued by Slovenian banks.[8] Households are considered the least risky customers. A- and B-rated claims still account for around 95% of all claims, but the share of B-rated claims increased significantly again in 2012 (from 10% to 18%). Non-performing claims account for 3.6% of total claims. Their share rose by just 0.2 percentage points relative to 2011. The stock of C-rated claims rose at a similar rate to 1.3% of the total.

Given the rapid deterioration in the quality of their assets, the banks intensified the creation of additional impairments and provisions, which amounted to EUR 1.5 bn, up 30% on the previous year. This was also one of the major factors in the Slovenian banking system's worst performance to date. In 2012 its losses amounted to around EUR 770 bn. By the end of last year impairments had already climbed to EUR 4.2 bn, up around 30% on the end of 2011.

In the first quarter the quality of bank claims deteriorated approximately half less than last year, but the deterioration was still relatively significant. The total stock of bad claims rose by EUR 226.7 m to EUR 6.9 bn, accounting for 14.5% of the total exposure of the Slovenian banking sector. The increase in bad claims is easing most notably in the sectors of construction, which was one of the most exposed

[8] It is thought that household loans have better collateral than corporate loans.

Figure 12: **Creation of impairments and provisions in the Slovenian banking system between 2006 and 31 March 2013**



Sources: Bank of Slovenia; calculations by IMAD.

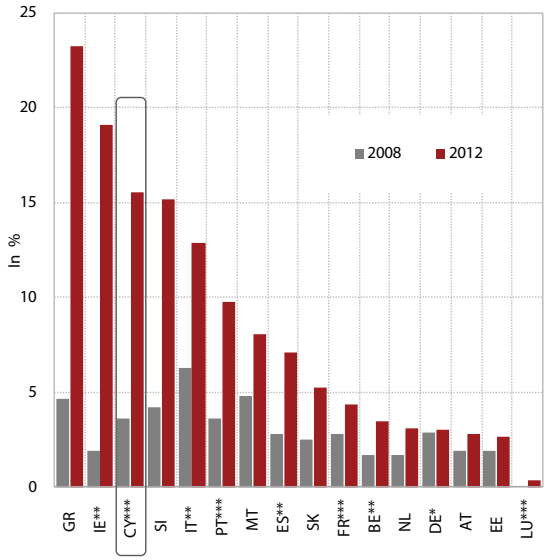
sectors in previous years, and manufacturing. But the quality of claims against financial services deteriorated significantly more than in the previous year. Given the slightly more moderate deterioration in the quality of their assets, the banks have created approximately 45% less impairments and provisions this year.

The adverse situation in the Slovenian banking system is also revealed by an international comparison of the shares of non-performing loans,[9] ***in terms of which Slovenia is at the top of the euro area.***[10] The share of non-performing loans in total exposure was 15%, around 3.5 percentage points higher than a year earlier. Only Greece and Cyprus recorded significantly higher increases in non-performing loans than Slovenia, while the increase in Ireland was slightly lower. In all other euro area countries non-performing loans rose much less, or the share of non-performing loans fell (e.g. Estonia, Slovakia). At the end of 2012 the Slovenian banking sector's non-performing claims (i.e. claims that are more than 90 days in arrears) amounted to EUR 6.9 bn, for which impairments and provisions totalling EUR 2.9 bn had been created. According to Bank of Slovenia figures, the collateral for these claims stood at EUR 6.3 bn at the end of the year (almost two thirds of which was real estate collateral). In the first quarter

[9] According to the internationally comparable figures based on IMF methodology, claims are considered non-performing if they are more than 90 days in arrears, while according to Bank of Slovenia methodology, non-performing claims are claims for which impairments and provisions exceed 40%.

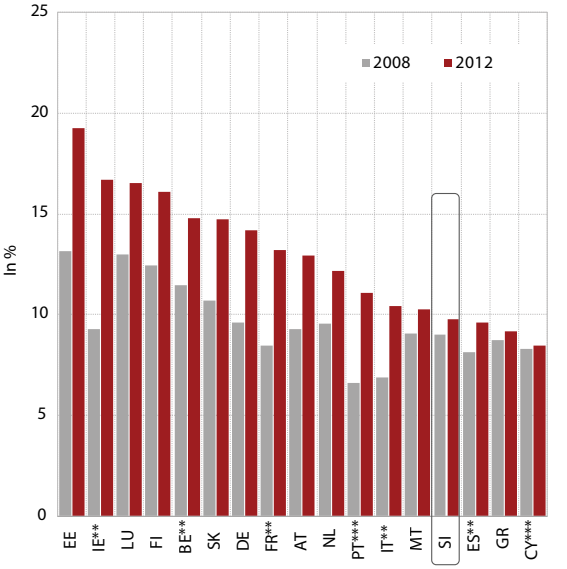
[10] Figures for Finland not available.

Figure 13: **Share of non-performing loans in individual euro area countries between 2008 and 2012, %**



Sources: Bank of Slovenia, IMF: Financial Soundness Indicators. Notes: *Figures for Q2 2011; **figures for Q3 2011.

Figure 14: **Tier 1 capital ratio in individual euro area countries in 2008 to 2012**



Sources: Bank of Slovenia, IMF: Financial Soundness Indicators. Notes: *Figures for Q2 2012; **figures for Q3 2012.

of this year the stock of non-performing claims increased to EUR 7.0 bn.

2.1.4 Insufficient capitalisation of the Slovenian banking system

The rapid deterioration in the Slovenian banking system is putting pressure on its capital adequacy, which is among the lowest in the euro area. Low capital adequacy is strongly impairing the banks' ability to absorb losses, so they are not able to take up additional risks, which is stifling their lending activity. Given the higher level of risk, they also have relatively limited access to fresh funding.

While the capital adequacy of banks in the euro area overall has strengthened notably since 2008, Slovenia has seen no significant improvement in this indicator. By the end of the first quarter of 2013, the government had earmarked around 2% of GDP for bank recapitalisations, but the capital adequacy of the Slovenian banking system nevertheless increased less than 1 percentage point to 9.8% (the arithmetic mean in the euro area is 12.9%). Despite the relatively high level of government intervention, the recapitalisations were solely designed to meet the minimum capital requirements at the government-owned banks, and were not carried out as a measure to revive lending activity. By the end 2012 when the Act Determining the Measures of the Republic of Slovenia to Strengthen Bank Stability was passed (Official Gazette of the Republic of Slovenia, No. 105/2012), no specific steps had yet been taken towards effective mitigation and management of risks at the government-owned banks. The result was further rapid growth in bad claims, with banks needing fresh capital to meet the minimum capital requirement again almost immediately after recapitalisation. One of the basic solutions provided by the law was the transfer of bad claims to the Bank Assets Management Company (BAMC) and capital increases at the banks in the restructuring scheme. The preliminary estimates indicate that EUR 3.3 bn should be moved to the DUTB at a transfer value of EUR 1.1 bn and that the banks should be recapitalised in the amount of EUR 900 m (for more see the National Reform Programme 2013–2014).

The low capital adequacy of the Slovenian banking system is also evident from the stress test results released by the European Banking Authority (EBA) and the Bank of Slovenia. The EBA stress tests reveal the two Slovenian banks that have been subject to stress tests and are predominantly government-owned to be among the worst-capitalised banks in the euro area. The general lack of capital in the Slovenian banking system is also revealed by the stress tests carried out by the Bank of Slovenia, according to which ten banks failed to meet the minimum requirements for the Tier 1 capital ratio at the end of 2012. The deficit stood at EUR 274 m, but would rise almost to EUR 1 bn in 2014 under the baseline scenario[11] and to more than EUR 2.4 bn

[11] The baseline scenario takes account of the latest GDP forecasts published by the Bank of Slovenia, while the changes in reference interest rates are determined on the basis on futures contracts.

under the adverse scenario[12] (Bank of Slovenia, 2013).

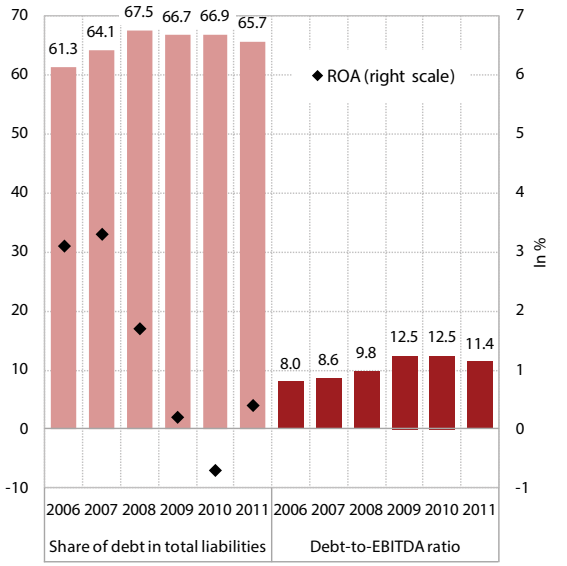
2.2 Limiting factors on the demand side

The largest limitation on the demand side is the high indebtedness of the Slovenian corporate sector. This is therefore exposed to significant liquidity pressure in connection with the repayment of maturing liabilities. Firms therefore have to waste time and energy dealing with financial difficulties, instead of focusing on their core business.

2.2.1 Indebtedness and financial structure of firms[13] with financial liabilities to banks

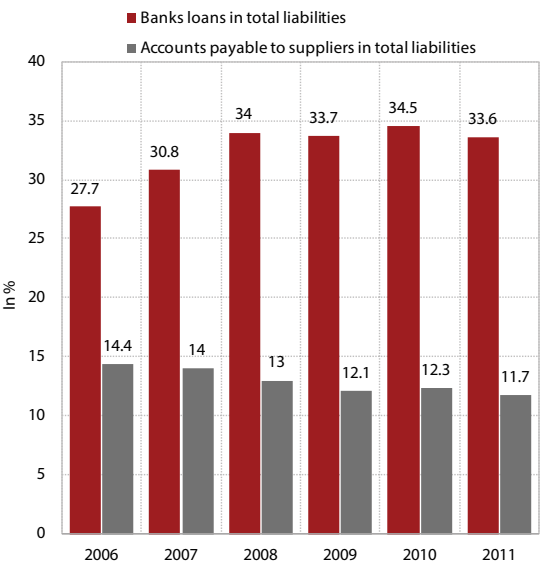
The indebtedness of Slovenian firms with financial liabilities to banks (as measured by the share of debt in total liabilities) has not declined significantly during the crisis. Debt thus accounted for around two thirds of total liabilities. More than half of the total corporate debt was accounted for by bank loans, which have represented around 34% of total liabilities during the crisis. Accounts payable to suppliers are also significant, but in recent years their share has declined slightly, which is estimated to be a consequence of a decline in turnover. Financial expenses for loans received from banks account for the largest proportion of the financial expenses from financial liabilities (the ratio of such expenses to revenues stood at 1.9% in 2011). Expenditure in connection with other sources of finance (financial expenses attributable to loans received from enterprises in the group, and issued bonds) accounted for a much smaller proportion. The share of expenses from bank loans or the revenues' loan burden stemming from bank loans has declined slightly during the crisis, but the decline was fairly modest and could have been larger in our assessment, given the significant reduction in the ECB's central interest rate. Financial expenses for bank loans were thus equivalent to around 2% of corporate revenues,

Figure 15: **Share of debt in total liabilities, in %, debt-to-EBITDA ratio and return on assets (ROA) at private sector firms, 2006–2011**



Sources: AJPES; calculations by IMAD.

Figure 16: **Share of total liabilities at private sector firms accounted for by financial liabilities to banks and accounts payable to suppliers in 2006–2011**



Sources: AJPES; calculations by IMAD.

[12] The adverse scenario assumes that in 2013 GDP growth will be two standard deviations lower than under the baseline scenario (-8.7%), before returning to the baseline level in 2014. It also assumes further sovereign downgrades for Slovenia, and a rise of 2 percentage points in interest rates. The rise in interest rates is not passed through in full to clients, which entails a lower interest margin.

[13] The main themes of this part of the section are indebtedness and the financial structure of Slovenian firms with financial liabilities to banks during the observation period of 2006–2011. It is only these firms that pose a risk of a deterioration in the banks' assets. The analysis is based on data from corporate balance sheets and profit and loss accounts for the 2006–2011 period collected by the Agency for Public Legal Records and Related Services (AJPES). The AJPES database includes all Slovenian companies other than those undergoing bankruptcy proceedings, which are no longer obliged to submit their annual reports and are therefore excluded from the database as of the year when they filed for bankruptcy. The analysis also excludes extreme outliers where growth in financial liabilities of firms to banks exceeded 50,000%, and holding companies, as they could distort the actual picture of Slovenian corporate borrowing. The final sample for the entire database covers 28,014 firms over an average four-year time-horizon (i.e. 112,056 units), which between 2006 and 2011 accounted for 85.6% of bank loans of all companies included in the database.

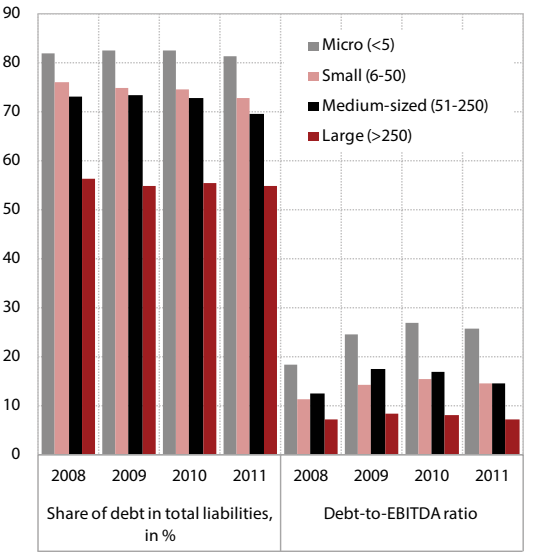
roughly 0.5 percentage points lower than the peak in 2008. The debt-to-EBITDA ratio,[14] a measure of a company's (in)ability to pay off its debts, also remains high. It stood at 11.4 in 2011.

2.2.1.1 Analysis of indebtedness by size of enterprises[15]

Micro enterprises are the most indebted and large enterprises the least indebted. At micro enterprises, indebtedness as measured by the share of debt in total liabilities exceeds 80%, and has not declined significantly during the crisis. Small and medium-sized enterprises are slightly less indebted (a share of debt in total liabilities of around 70%). They have reduced indebtedness most during the crisis. Small enterprises have been constantly reducing indebtedness during the crisis. In 2012 it was thus 3.3 percentage points lower than before the outbreak of the crisis. Medium-sized enterprises recorded an increase in indebtedness in the first year of the crisis, and then reduced it in the following years. In 2011 it was 3.5 percentage points lower than before the crisis. By far the lowest indebtedness is recorded by large enterprises, where debt accounts for only half of total liabilities, the figure having declined by 1.3 percentage points during the crisis.

Micro, small and medium-size enterprises are the most dependent on bank loans, and also have the most limited access to this type of financing. At these three categories of enterprises liabilities to banks account for 38% of total liabilities on average, compared with 25% at large enterprises. Micro, small and medium-sized enterprises reduced the share of bank borrowing during the crisis, in contrast to large enterprises where this share actually rose slightly (by 0.4 percentage points). The latter was the result of a decline in total liabilities, which in 2011 was slightly larger than the decline in financial liabilities to banks (this was almost half smaller than at other enterprises). The share of long-term financial liabilities[16] to banks

Figure 17: **Share of debt in total liabilities, in %, debt-to-EBITDA ratio by size class of private sector enterprises, 2006–2011**

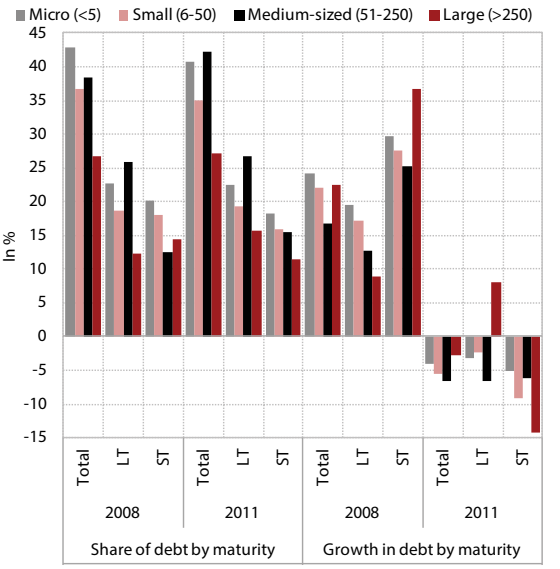


Sources: AJPES; calculations by IMAD.

relative to total liabilities continues to grow. In 2008 long-term financial liabilities to banks started to rise at all categories of enterprises, which was largely attributable to the restructuring of short-term debt into long-term debt whereby the banks eased the liquidity pressure on enterprises.

The decline in sales revenues meant that corporate debt servicing capacity (in particular at micro, small and medium-sized enterprises) declined

Figure 18: **Share of financial liabilities to banks in total liabilities by maturity, and their growth by size of enterprise at enterprises in the private sector, 2008 and 2011**



Sources: AJPES; calculations by IMAD.

[14] EBITDA is defined as operating profit/loss plus depreciation.

[15] The results of the analysis of indebtedness of Slovenian enterprises with financial liabilities to banks by size of enterprises are given below. Micro enterprises are those with a headcount of up to five employees, small enterprises have six to 50, medium-sized enterprises 51 to 250, and large enterprises more than 250 employees. Micro enterprises make up 58% of the overall database, small enterprises 34%, medium-sized enterprises 6% and large enterprises 2%. The total headcount averaged around 316,276: 13,815 (4%) at micro enterprises, around 68,456 (22%) at small enterprises, around 81,440 (26%) at medium-size enterprises and 152,565 (48%) at large enterprises.

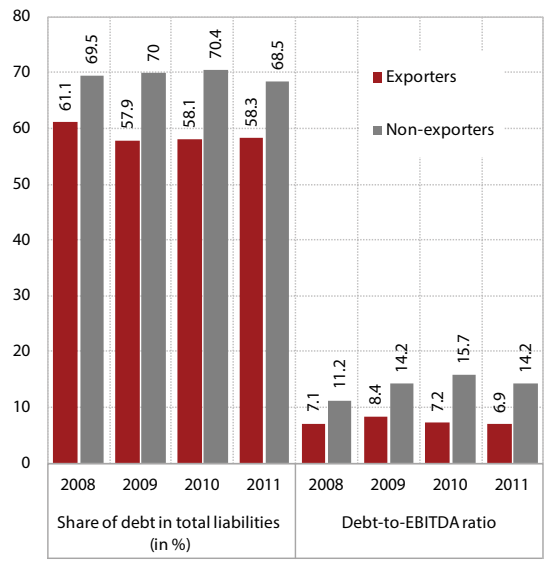
[16] In 2011 the stock of long-term financial liabilities to banks actually declined, but the decline was smaller than that in short-term liabilities.

substantially in the first two years of the crisis. In 2011 it improved slightly at all firms, but remained problematic. The highest debt-to-EBITDA ratio was recorded by micro enterprises (26), while the lowest was at large enterprises (approximately 7).

2.2.1.2 Analysis of indebtedness by export orientation of enterprises[17]

Analysis of indebtedness by export orientation of enterprises as measured by the ratio of debt to total liabilities reveals that firms focusing on the domestic market are more indebted than those focusing on foreign markets. During the crisis indebtedness has declined at non-exporting and export-oriented firms (by 1 percentage point and 2.8 percentage points respectively), but with different dynamics. The indebtedness of non-exporters had already increased slightly in 2010 and 2011, primarily in connection with the recovery of export markets. The increase in indebtedness at exporters was largely the result of an increase in accounts payable to suppliers, in contrast to bank loans, which have declined throughout the crisis. Indebtedness at non-exporters increased in the first two years of the crisis (by nearly 1 percentage point), before declining in 2011 (by almost 2 percentage points). The decline in indebtedness at non-exporters was thus a result of both a decline in bank loans and a decline in accounts payable to suppliers. Measured as the ratio of debt to EBITDA, indebtedness at exporters declined to the pre-crisis level in 2010, and then declined again slightly in 2011. Indebtedness at non-exporters was still more than a quarter higher than in 2008.

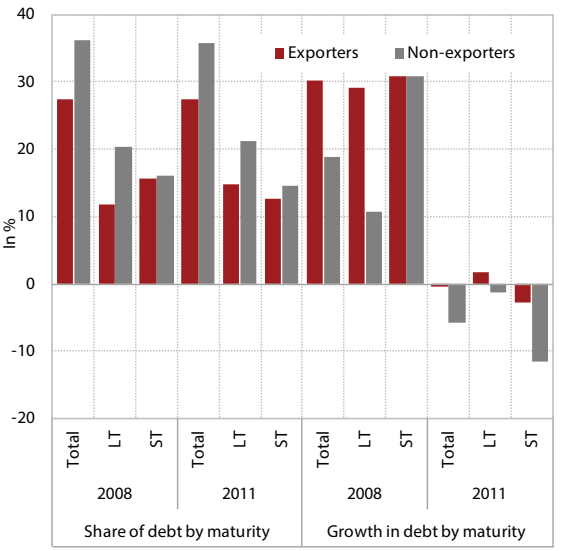
Figure 19: **Share of debt in total liabilities, in %, debt-to-EBITDA ratio by export orientation of private sector enterprises, 2008–2011**



Sources: AJPES; calculations by IMAD.

Non-exporters are also more dependent on bank financing. The share of their financial liabilities to banks is more than 8 percentage points higher than at exporters. However, long-term lending to non-exporters also came to a halt in 2011, while long-term financial liabilities to banks were still rising at exporters. Nevertheless, the share was much lower than that of non-exporting firms.

Figure 20: **Share of financial liabilities to banks in total liabilities by maturity, and their growth by export orientation at private sector enterprises, 2009–2011**



Sources: AJPES; calculations by IMAD.

2.2.1.3 Analysis of indebtedness by activity of enterprises[18]

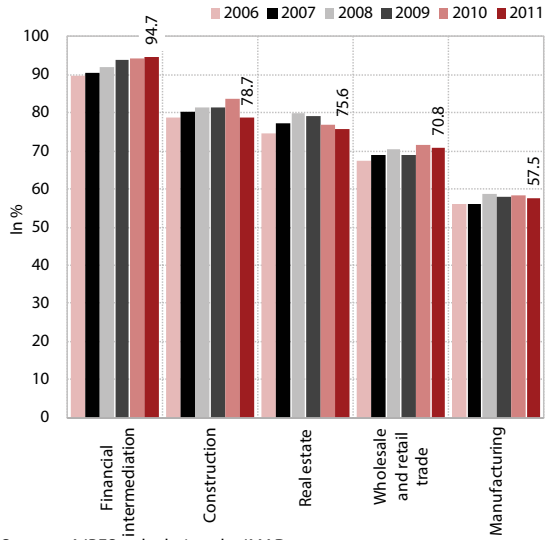
Analysis of private sector indebtedness by activity shows that in 2006–2011 the most heavily indebted firms were in the sectors of financial intermediation activities, construction, wholesale and retail trade, and real estate, leasing and business services (real estate activities).[19] In the period before

[17] Export-oriented firms are those whose sales revenues on foreign markets exceed sales revenues on the domestic market. Export-oriented firms make up 10% of the total database, and domestic-oriented enterprises 90%; the latter account for roughly 65% of the total value added generated by firms with financial liabilities to banks.

[18] In order to ensure greater sample consistency, the data is broken down according to the 2002 Standard Classification of Economic Activities (SKD 2002).

[19] In addition to these most indebted sectors, manufacturing was also analysed, as an important part of the Slovenian economy. The coverage of firms in financial intermediation is very modest, as the database lacks the figures for banks and insurance corporations, which account for the majority of this sector. The financial intermediation sector was therefore not analysed in detail.

Figure 21: **Share of debt in total liabilities by different private sector activities, 2008–2011**



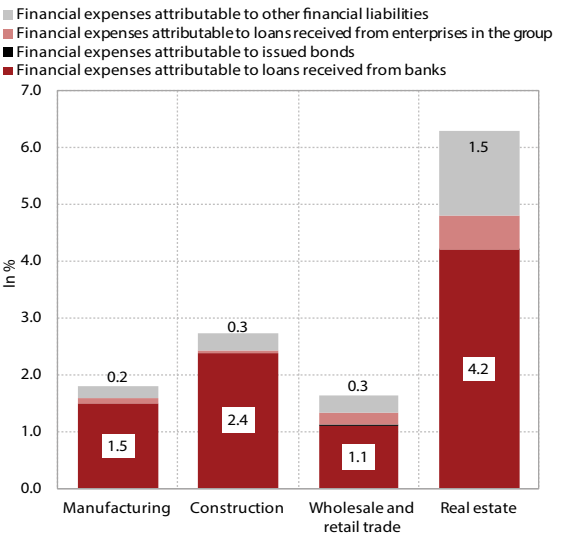
Sources: AJPES; calculations by IMAD.

the crisis (2006–2008), the share of debt in total liabilities increased across all sectors, while the debt dynamics in 2009–2011 were fairly uneven. In real estate activities, construction and manufacturing indebtedness declined, while in other sectors it rose at a much more moderate pace. One of the reasons for the decline in indebtedness in the most heavily indebted activities was corporate failures (bankruptcies) in these sectors, as a result of which these firms no longer submit financial accounts and are not included in the database as of the year of filing for bankruptcy. However, this does not lessen the pressure on the banks, as they have to create additional impairments and provisions, because the claims against these firms remain on their balance sheets. According to the Bank of Slovenia's Financial Stability Review (2013), non-performing claims against firms undergoing bankruptcy proceedings account for a large (and increasing) proportion of the banks' non-performing claims. In March they totalled EUR 2.6 bn, or 48% of all non-performing claims against non-financial corporations, compared with 38% in December 2011. The proportion of total classified claims against non-financial corporations accounted for by firms in bankruptcy stands at 11.7%.

The debt-to-EBITDA ratio, which measures corporate debt servicing capacity, has increased significantly during the crisis, particularly in the most heavily indebted sectors, which shows that firms are finding it increasingly difficult to repay maturing liabilities. The increase was the result of free cash flow decreasing by almost a fifth between 2009 and 2011.[20] The debt-to-EBITDA ratio in the analysed sectors ranged from 7 (manufacturing) to 56 (construction) in 2011.

The breakdown of financial expenses from financial liabilities is similar across sectors, with the exception of real estate activities (see Figure 22). As is evident from the figure, all firms in the sectors analysed primarily take out bank loans and therefore have high financial expenses for interest repayments. They rarely opt for borrowing from affiliates and almost never issue bonds. In 2009 financial expenses for loans received from banks declined considerably, only to start growing again in 2010 (except in wholesale and retail trade and real estate activities), as in addition to indebtedness,[21] interbank interest rates also began to rise at the end of 2010, although they started to fall again at the end of 2011 and are currently historically low. Financial expenses for bank loans thus declined in construction (by 12.8%)[22] and wholesale and retail trade (by 5.4%), while increasing in manufacturing (by 4.8%) and real estate activities (by 1.9%).

Figure 22: **Ratio of financial expenses from loans to sales revenues by different private sector activities, 2011**



Sources: AJPES; calculations by IMAD.

Of the exposed sectors, the largest shares of financial liabilities to banks in total liabilities were recorded in construction and real estate activities. In the construction sector the figure actually increased slightly, while total exposure decreased as a result of the decline in the share of accounts payable

[20] In the first two years of the crisis EBITDA declined (in 2009 in particular), while in 2011 it rose almost by 6%.

[21] In 2010 indebtedness rose in all exposed sectors other than real estate activities, where it was down 2.3 percentage points.

[22] This is also estimated to be the result of the bankruptcies of certain major construction firms, which are thus no longer included in the database.

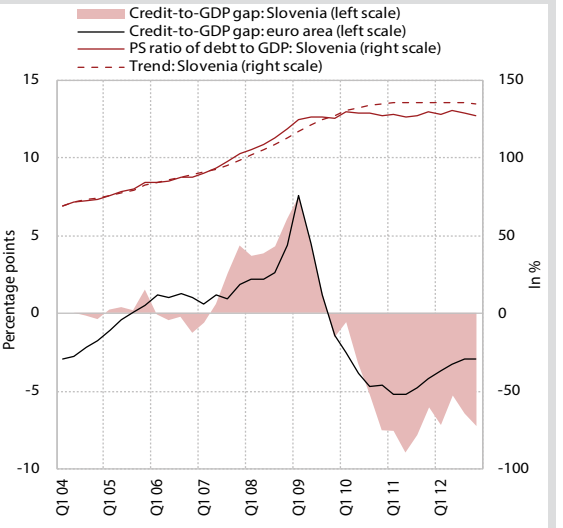
Box 2: **Private sector credit-to-GDP gap**

The private sector credit-to-GDP gap is an instrument of macroprudential supervision[1] of the financial system of a country or group of countries. The credit-to-GDP gap illustrates time-varying systemic risk, and is important from two aspects. The first is the early identification of excessive imbalances and vulnerabilities in a country, for policymakers to be able to establish proper tools and take appropriate action even in the period of economic and financial expansion and thus prevent excessive contraction in times of financial and economic crisis. The second relates to indications of when a crisis is going to end and when sustainable growth will return to the economy and financial markets so that preventive mechanisms and measures will no longer be needed.

Various research[2] has shown that measures that reveal excessive debt growth are a good indicator of borrowers' future inability to repay loans. However, as pointed out in a Bank of England study (2011), they should be used with caution as they tend to be effective only in good economic times, while they lag during a crisis. The Basel Committee on Banking Supervision nevertheless suggested regular monitoring of the private sector credit-to-GDP gap as the main tool for the calibration and introduction of counter-cyclical capital buffers in compliance with Basel III rules.

The private sector credit-to-GDP gap is the deviation (expressed in percentage points) of the ratio of private sector debt to GDP from its long-term trend. The Basel Committee on Banking Supervision recommends that the latter should be computed by means of a one-sided Hodrick-Prescott filter[3] with a smoothing coefficient of 400,000[4] (for details see Basel Committee on Banking Supervision, 2010). At EU level, the credit-to-GDP gap also started to be calculated by the European Systemic Risk Board (ESRB),[5] which uses it as one of the indicators for the assessment of macroeconomic risks. Its results are different from the IMAD results because of a different definition of the measure for debt (the ESRB uses a narrower definition, i.e. debt securities and loans to non-financial corporations) and a different filter used to compute the long-term trend (for more on the filter used see Alessi and Detken, 2011). Nevertheless, the ESRB results also show a positive credit-to-GDP gap in Slovenia, albeit a narrower one.

Figure 23: **Private sector ratio of debt to GDP and trend in Slovenia (left scale), and comparison of credit-to-GDP gaps in Slovenia and the euro area**



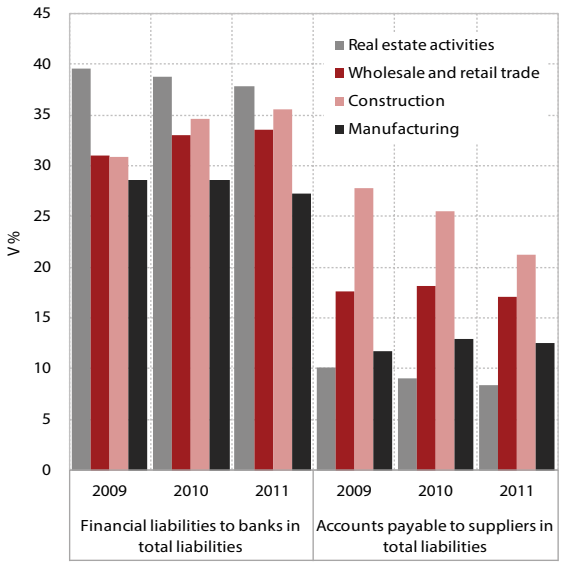
Sources: Bank of Slovenia, ECB, SURS; calculations by IMAD.
Note: PS: private sector.

[1] Macro-prudential supervision prevents financial instability as a result of macroeconomic developments and the development of the financial system as a whole.
[2] Borio and Lowe, 2002 and 2004; Derehmann, M., Borio, C., Gambacorta, L., Jiménez, G., Trucharte, C., 2010; Schularick and Taylor, 2012.
[3] In the calculation of the one-sided long-term trend, the one-sided Hodrick-Prescott filter uses only information available at the time when assessments are made.
[4] Empirically, the duration of business cycles ranges from 4 to 8 years in OECD countries (see Cotis and Coppel 2005. When analysing business cycles by quarterly data, a smoothing parameter of 1,600 is used by default and also as recommended by Hodrick and Prescott; when using frequency analysis, a 7.5 year duration of the business cycle is implicitly assumed. Far less is known about the duration of credit cycles. An indication is provided by the length between two systemic crises, which ranges from 5 years to around 20 years. The median is around 15 years, implying that the credit cycle is three to four times the length of the business cycle (Drehmann, Borio, Gambacorta, Jiménez, Trucharte, 2010). In their working paper Drehmann et al assessed the impact of different smoothing parameters: 1,600 (assuming that credit cycles have the same length as business cycles); 25,000 (assuming that credit cycles are twice as long as business cycles); 125,000 (assuming that credit cycles are three times as long as business cycles); and 400,000 (assuming that credit cycles are four times as long as business cycles).
[5] The ESRB is an independent EU body tasked with the macro-prudential oversight of the financial system within the EU. It analyses risks, issues warnings and recommendations (which can be public or confidential), and monitors the follow-up to warnings and recommendations. The ESRB (2013) points to a potential vulnerability of the financial system on the basis of a set of quantitative indicators for six areas (interlinkages and composite measures of systemic risk, macro risk, credit risk, funding and liquidity, market risk, and profitability and solvency).

It is estimated that in Slovenia excess debt accumulated mainly in the period between the second quarter of 2007 and the third quarter of 2009 inclusive. The ratio of private sector debt to GDP was on average approximately 3.8 percentage points above the long-term trend or sustainable level. The positive credit-to-GDP gap in 2009 was mainly the result of the pronounced real contraction in economic activity (7.8%), given that the credit flow that year was already fairly modest. Excessive lending activity was recorded in 2007 and 2008, when Slovenia exceeded the threshold for private sector credit flow (15% of GDP) used by the European Commission to determine macroeconomic imbalances. These years saw excessive borrowing at non-financial corporations in particular, which later proved unable to service their debts, which were often economically unjustified, particularly at firms focusing on the domestic market. The contribution of Slovenian households to the credit bubble was moderate (it was largest in 2007, but even then was merely around 5%). The negative credit-to-GDP gap remained wide in 2012, as a result of an even tighter credit crunch (loan growth in 2012 stood at -4.3%) and low economic activity, which also had a profound impact on investment by sound export-oriented high-technology firms, and thus on a further deepening of the economic and financial crisis.

Our calculations also show that the credit-to-GDP gap in Slovenia in that period exceeded the euro area average, where an excessive build-up of debt was mainly seen from the third quarter of 2005 to the third quarter of 2009 inclusive. The ratio of private sector debt to GDP was on average 2 percentage points above the long-term level in that period. In 2009 the positive credit-to-GDP gap in the euro area was also a result of modest lending activity and the contraction in economic activity, which was almost half smaller than in Slovenia in real terms (-4.4%).

Figure 24: **Share of bank loans and accounts payable to suppliers in total liabilities of private sector enteprises, 2009–2011**



Sources: AJPES; calculations by IMAD.

to suppliers.[23] The increase in the share of financial liabilities to banks was primarily a consequence of the substantial contraction in total liabilities, as financial liabilities to banks declined less, by around 15%.[24] In contrast to previous years, long-term financial liabilities to banks also fell in 2011, which we estimate was attributable to the banks significantly restricting the restructuring of short-term loans into long-term loans; the decline was nevertheless much smaller than the decline in short-term loans.

[23] It is still relatively high compared with other sectors.

[24] The decline in total liabilities is also attributable to the bankruptcies of certain major construction firms, which are thus no longer included in the database.

2.2.1.4 Bank exposure[25] by sector in 2012[26]

The Slovenian banking system's exposure to the Slovenian economy declined in 2012 for the first time since the outbreak of the financial crisis. This was a consequence of both lower borrowing by the sector of public administration, defence and compulsory social security, and a much stronger reduction in other sectors' liabilities to domestic banks. The total exposure to all sectors thus declined by around EUR 900 m. The banks were still primarily financing the least risky sectors, such as public administration, defence and compulsory social security,[27] where exposure rose by just over EUR 730 m, only 7% less than in the previous year. According to our estimate, this was primarily the result of government loans and investment in treasury bills by government-owned banks. Exposure to the electricity, gas and water supply sector also increased relatively sharply (by around EUR 240 m). Of the other sectors, only information and communication is notable, with exposure increasing by around EUR 60 m.

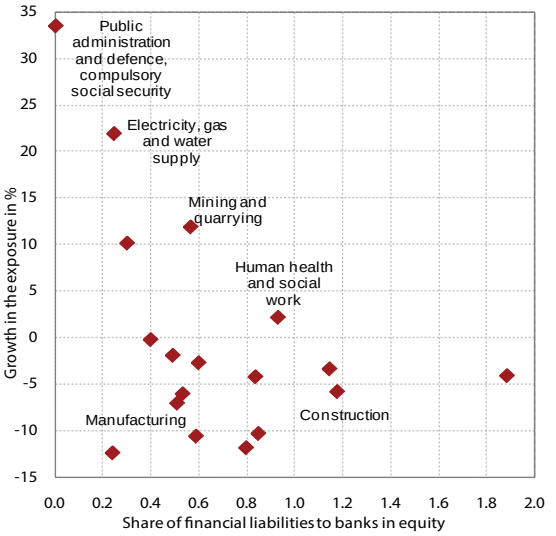
In 2012 the banks were increasingly reducing their exposure to most other sectors. Exposure to the wholesale and retail trade sector declined for the

[25] In addition to loans and securities of individual firms at banks, total exposure comprises other bank claims against firms measured at repayment value. This category also includes off-balance-sheet exposures, such as guarantees and warranties.

[26] The figures used to describe 2012 developments in individual sectors are classified according to the SKD 2008, and are therefore not fully comparable with those used in the analysis in previous paragraphs.

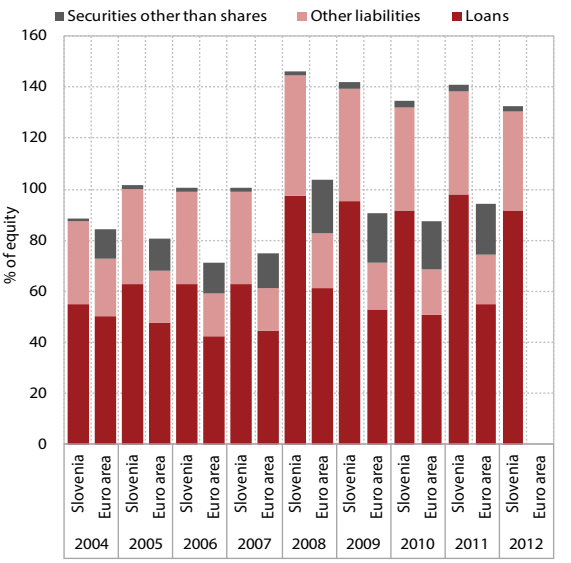
[27] The proportion of total exposure accounted for by public administration, defence and compulsory social security has thus more than doubled during the crisis, reaching 6.1% at the end of 2012.

Figure 25: **Share of financial liabilities to banks and growth in the exposure of the Slovenian banking system to individual sectors**



Sources: Bank of Slovenia, AJPES; calculations by IMAD.

Figure 26: **Indebtedness at non-financial corporations and NFIs in Slovenia and the euro area**



Sources: Bank of Slovenia, Eurostat; calculations by IMAD.

fourth consecutive year, and was down more than EUR 480 m on the previous year.[28] Exposure to the manufacturing sector dropped only slightly less (EUR 460 m), while exposure to the transportation and storage sector also declined significantly, by around EUR 280 m. For the first time since the outbreak of the crisis, the banks reduced their exposure to the construction sector (by around EUR 210 m). Exposure to manufacturing declined for the second consecutive year, by EUR 120 m, just over 35% more than in 2010. Last year's decline was again primarily the result of a decline in exposure to industries of higher technological intensity, such as the chemical industry and the manufacture of computer, electronic and optical products and electrical equipment; among other manufacturing activities, there was also a significant decline in exposure to the manufacture of textiles, clothing, leather and leather products.

2.2.1.5 International comparison of the indebtedness of the Slovenian economy

Indebtedness at non-financial corporations and NFIs in Slovenia is above the euro area average. Although the stock of loans raised at domestic banks has declined substantially in the last three years (by around 12%) and is only 5% above the 2007 figure, the indebtedness of the Slovenian economy is still much higher than before the crisis. This is primarily due to a significant decline in equity at non-financial corporations and NFIs as a result of adverse developments on capital markets. Given their poor performance, Slovenian firms are no longer able to strengthen their equity base, which has significantly increased the indebtedness of the Slovenian economy. In 2013 total corporate indebtedness as measured by the overall debt-to-equity ratio thus stood at 130%, down approximately 10 percentage points on 2011. Only Greece, Italy and Spain recorded higher corporate indebtedness than Slovenia.[29]

The poorly developed capital market has a significant impact on the financial structure of the Slovenian economy, which is thus more dependent on short-term financing. In addition to lower equity, this is also reflected in a negligible level of financing via debt securities, one of the lowest in the euro area (less than 15% of the euro area average). This is also partly a result of the small size of the Slovenian economy, where the majority of firms are small and medium-sized, for whom financing via debt securities is not cost-effective because of the relatively high cost. It is nevertheless our assessment that the share of this type of financing could also be higher in Slovenia. However, it would first be necessary to provide for an efficient and liquid capital market to help issuers and holders of these securities reduce transaction costs.

2.2.2 Modest economic growth forecast

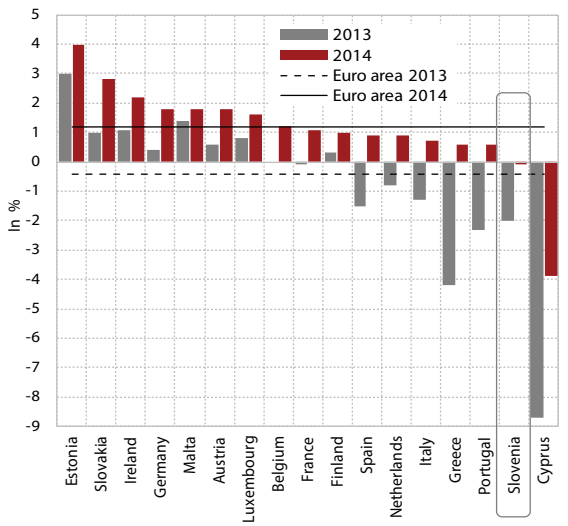
Given the weak economic activity, demand for loans is expected to decline further. The modest economic activity is also being reflected in lower corporate

[28] Since the end of 2008 exposure to this sector has declined by around EUR 1 bn.

[29] Figures for other euro area countries refer to 2011.

demand for loans, both for working capital and for investment, as capacity utilisation is still low. Unable to settle maturing liabilities, firms are mainly raising loans for debt restructuring, and banks are mitigating their liquidity problems to a certain extent by granting these loans. Corporate loan demand declined more than in the euro area overall, according to the Bank of Slovenia figures. In addition, Slovenian banks tightened their credit standards more than those in the euro area overall, albeit slightly less than in 2008 and 2009.

Figure 27: **European Commission economic growth forecasts for Slovenia and other euro area countries for 2013 and 2014**



Source: European Commission (2013).

Demand for loans will remain low. The prospects for economic growth in Slovenia are quite unfavourable. IMAD[30] is forecasting a decline of 1.9% in GDP in 2013, and growth of 0.2% in 2014.[31] The growth forecasts for both years are much lower than the euro area average, and Slovenia is also in the group of countries whose GDP growth forecasts were revised significantly downwards by the European Commission in the spring. The projections for Slovenia's GDP growth are thus similar to those for the euro area countries most exposed to the financial crisis. The main downside risks to economic growth in Slovenia are related to the state of the Slovenian financial system and the indebtedness of the Slovenian economy, and any delay in structural reforms could additionally reduce the forecasts (European Commission, 2013). To emerge from the crisis, it is therefore essential to establish an efficient institutional framework that would improve the rule of law and ensure the efficacy of regulatory and supervisory functions, and to ensure the withdrawal of the government from the corporate sector to prevent it from directly intervening in the decision-making of economic entities (see Development Report, 2013).

[30] See Spring Forecast.

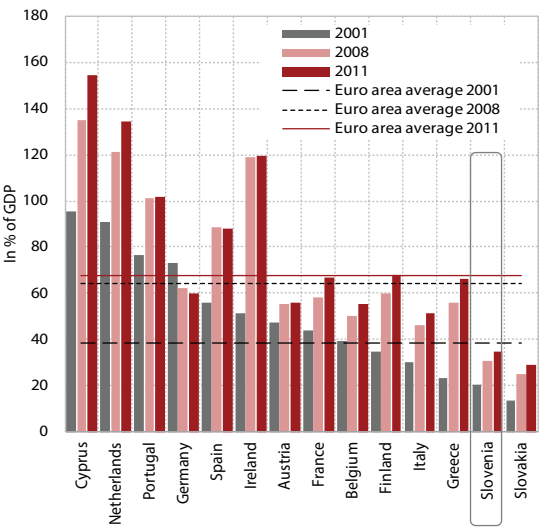
[31] The European Commission is forecasting a decline in GDP of 2.0% in 2013 and a decline of 0.1% in 2014, while the Bank of Slovenia is forecasting a decline of 1.9% in 2013 and growth of 0.5% in 2014.

2.2.3 Modest household demand for loans

Household demand for loans is also declining more and more as a result of low economic activity. It is thought that this is the result of a further deterioration in the labour market situation, and government fiscal consolidation measures such as the reduction of the net wage bill in the public sector and more restrictive social transfer policy. Household disposable income thus continues to decline, as does household purchasing power, all of which is increasing uncertainty in household consumption and investment. The decline in disposable income is also reducing creditworthiness of households, particularly those with lower disposable income. In view of the extremely uncertain economic situation, households are fairly cautious about their spending. This is also indicated by a decline in private consumption, one of the largest recorded in 2012, even though Slovenian households are among the least indebted in the euro area.

Households remain very cautious in purchasing housing. They are postponing real estate purchases because they expect prices to fall further. Their creditworthiness also declined. The fall in housing loans (see 1.2.2) is also related to the deterioration in

Figure 28: **Percentage ratio of liabilities to GDP at households and NPISHs in the euro area**



Source: Eurostat.

the conditions on the supply side as a result of the significant tightening of credit standards.[32] According to SURS figures, in 2012 the number of housing transactions was down around 35% on its peak of 2007.

In 2011 aggregate household indebtedness rose slightly, but remained low compared with euro area countries. Indebtedness as measured by the ratio of liabilities to financial assets rose in Slovenia relative to 2010 (by 0.8 percentage points to 33.1%), the highest figure since comparable data have been available.[33] According to the annual financial accounts, household liabilities declined for the first time, by 0.4%, but slightly less than financial assets, which fell by 3.1%. Despite the increase, household indebtedness was still slightly lower than in the euro area overall, while indebtedness as measured by the ratio of liabilities to GDP was significantly lower. As a result of a decline in liabilities and an increase in GDP, it declined by 0.7 percentage points in 2011 to 34.8%, compared with more than 69% in the euro area overall.

Household indebtedness declined again in 2012. The ratio of financial liabilities to financial assets was at 32.6%. Given the further fall in disposable income, household financial assets[34] continued to decline (by 0.7% in 2012). Higher household deleveraging was reflected in a larger decline in financial liabilities (-2.6%) and therefore a modest fall in indebtedness, while household indebtedness as a ratio to GDP declined to 34.5%.

[32] In addition to the imposition of higher premiums, which mainly poses a risk in the event of a potential future rise in interbank interest rates, requirements for additional loan collateral have increased markedly.
[33] Since 2001.
[34] Currency and deposits, securities other than shares, loans, shares and other equity, insurance technical reserves, other accounts receivable.

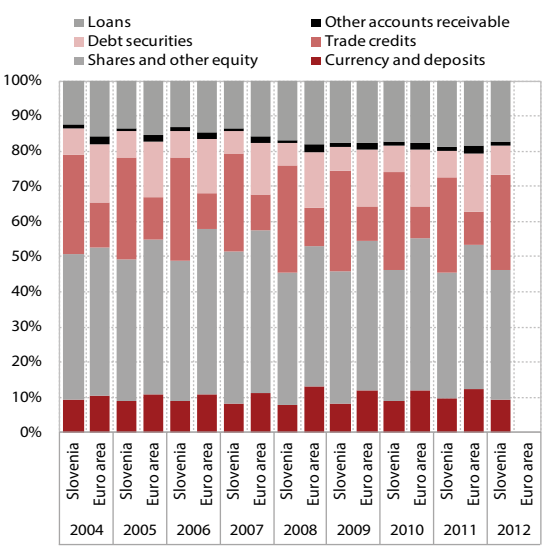
3. Corporate financial structure

It is estimated that one of the reasons that the latest financial crisis has had a greater adverse impact on the economy in Slovenia than in the euro area overall is the unfavourable financial structure of non-financial corporations and NFIs. Non-financial corporations and NFIs in Slovenia typically have a lower ratio of financial assets to financial liabilities than their counterparts in the euro area overall. Slovenian firms also have fewer liquid financial assets such as currency, deposits and debt securities that are readily convertible to cash (provided that there is an efficient capital market) at low transaction costs. By contrast, they have an above-average proportion of short-term financial liabilities, which is putting them under severe liquidity pressure in the current situation of highly restricted financing.

3.1 Structure of financial assets

The financial structure of Slovenian non-financial corporations and NFIs again deteriorated slightly in 2012. The ratio of financial assets to financial liabilities at non-financial corporations and NFIs in Slovenia totals just 57.1%, compared with 80% in the euro area overall.[35] The Slovenian economy has an above-average proportion of less-liquid financial assets, such as trade credits, which given the pervasive lack of payment discipline is additionally stifling liquidity,

Figure 29: **Structure of financial assets of non-financial corporations and NFIs in Slovenia and the euro area, 2004–2012**



Sources: Bank of Slovenia, Eurostat; calculations by IMAD.

[35] Data for EMU refers to 2011.

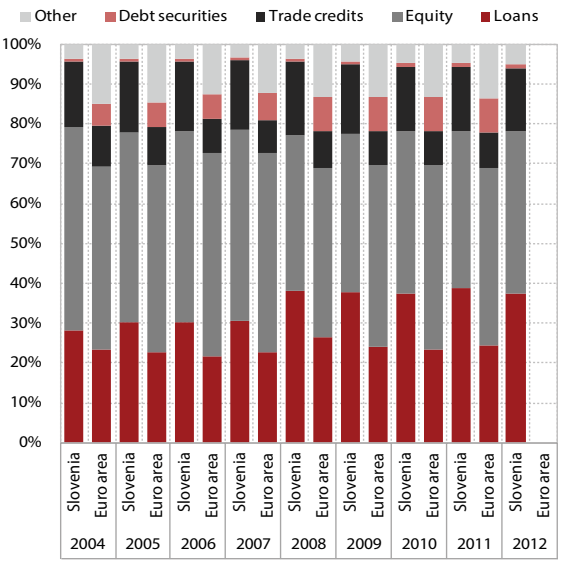
while the proportion accounted for by currency and debt securities, some of the more liquid assets if the capital market functions properly, is much lower than in the euro area overall.

In 2012 the stock of financial assets of Slovenian non-financial corporations and NFIs declined for the third consecutive year. At 2.7%, the decline was only slightly smaller than in the previous two years. This time the greatest contribution to the decline (around 2 percentage points) came from a fall in loans granted (down more than a tenth). This indicates that in having to cope with increasing liquidity pressures the Slovenian economy is reducing investment (including inter-company loans), which is putting additional liquidity pressure on firms. Other accounts receivable[36] contributed approximately half less to the decline in corporate and NFI financial assets than loans. They have been falling since 2009, partly as a result of modest economic activity in our assessment. By contrast, investment by non-financial corporations and NFIs in securities other than shares strengthened significantly, primarily as a result of an increase in this type of investment by insurance corporations, which placed free financial assets in government securities. This is attributable to the higher valuation of government securities in view of the slight improvement in the situation on financial markets.

3.2 Structure of financial liabilities

The structure of financial liabilities did not improve much in 2012, and remained relatively unfavourable. The stock of financial liabilities of Slovenian non-financial corporations and NFIs declined by around 2% or EUR 2 bn, which can primarily be attributed to a decline in loans as the Slovenian economy rapidly deleveraged. Having recorded the sole significant increases since 2009 (which in our assessment was also the result of maturity debt restructuring), the stock of long-term loans to non-financial corporations and NFIs declined by as much as 5.7% or EUR 1.6 bn in 2012. Given the adverse economic situation, firms continued to reduce other accounts payable. By contrast, the stock of debt securities strengthened slightly in 2012, and was up 2.5% on the previous year. However, given the small proportion of total liabilities that it accounts for, it was unable to significantly compensate for the decline in financing. The maturity structure of debt securities was also unfavourable, as short-term securities recorded the strongest growth. The stock of equity rose by just over 1%, but this was largely attributable to positive developments on the Ljubljana Stock Exchange.

Figure 30: **Structure of financial liabilities of non-financial corporations and NFIs in Slovenia and the euro area, 2004–2012**



Sources: Bank of Slovenia, Eurostat; calculations by IMAD.

A comparison with the euro area reveals that Slovenian non-financial corporations and NFIs are still more dependent on short-term financing than their counterparts in the euro area overall, while long-term financing remains relatively insignificant. In the past changes in capital in Slovenia were influenced by general developments on the capital markets, and much less by owners taking an active role in supporting the development of their firms via capital increases. This was to a large extent also a result of the ownership structure, given that a significant part of the Slovenian economy is still owned by the government or by state-owned firms. As a result of the poorly developed capital market, debt securities are also a relatively insignificant source of financing. Slovenian non-financial corporations and NFIs thus mainly rely on short-term financing, which puts them under more liquidity pressure in times of crisis. They thus have to expend a lot of energy dealing with financial problems instead of focusing on their core business.

3.3 Foreign corporate financing

A major feature of foreign financing for Slovenian firms is that direct foreign financing, which is reflected in an increase in foreign liabilities of 'other sectors', exceeded the pre-crisis level in 2012, with

[36] Around 86% of other accounts receivable are trade credits and advance payments.

only foreign loans still down. Nevertheless, the inflow of foreign financing via these channels has been very modest since 2008; the increase in 2012 was again significantly smaller (EUR 145.4 m) than that in 2011 (EUR 1,017.6 m). With regard to the banks' foreign liabilities that represent a potential source of corporate credit, the situation is even worse: these are still far below the pre-crisis level. Moreover, since 2009 there has been a significant outflow (return) of foreign financing via these channels, which intensified in 2011 and even more so in 2012. In short, foreign sources of corporate financing have been declining drastically since 2009, particularly in 2012. To be more precise, there has been a massive (and increasing) outflow of foreign financing, which hit a record high of EUR 2,407.1 m in 2012. Firms now in particular lack the foreign financing that they used to obtain via intermediation by domestic banks.

The major sources of foreign corporate financing are liabilities of 'other sectors' (including other firms) and the banks' foreign liabilities[37] that represent a potential source of corporate credit (Table 1). The former are direct sources of corporate financing, while the latter are indirect. The stock and trends in foreign corporate financing were examined in analysis of Slovenia's international investment position between 2002 and 2012.

Until 2008 the total stock of foreign financing for firms, i.e. actual and potential (via banks) financing, had been rising very rapidly (it increased by almost 3.3 times between 2002 and 2008); since then it has declined continually. The decline was entirely the result of a fall in bank lending from foreign funding, while direct foreign financing continued to increase, albeit at a significantly slower pace. Between 2008 and 2012 firms received EUR 3,319.2 m in additional foreign financing via an increase in direct foreign liabilities, but at the same time there was also an outflow of foreign financing via banks in the high amount of EUR 7,230.2 m. Actual and indirect corporate foreign financing thus declined by EUR 5,911.0 m during this period, and by EUR 1,555.2 m in 2011 alone and as much as EUR 2,407.1 m in 2012. Between 2002 and 2008 the total stock of direct foreign corporate financing, which is reflected in foreign liabilities of 'other sectors', was continuously increasing; it declined slightly in 2009, then started rising steadily again, albeit at fairly modest rates. That foreign liabilities of 'other sectors' have been rising throughout this period except in 2009 reveals that firms have consistently recorded positive inflows of foreign financing. This also holds true for the years of the economic crisis, i.e. from 2008 onwards. Although growth in foreign financing slowed markedly in 2009 (-2.4%) and 2010 (2.0%), it rose notably in 2011 (5.2%)

Table 1: **Liabilities of 'other sectors' and bank liabilities that are a source of corporate credit in the International Investment Position of Slovenia: liabilities by variable, 2002–2012, EUR m**

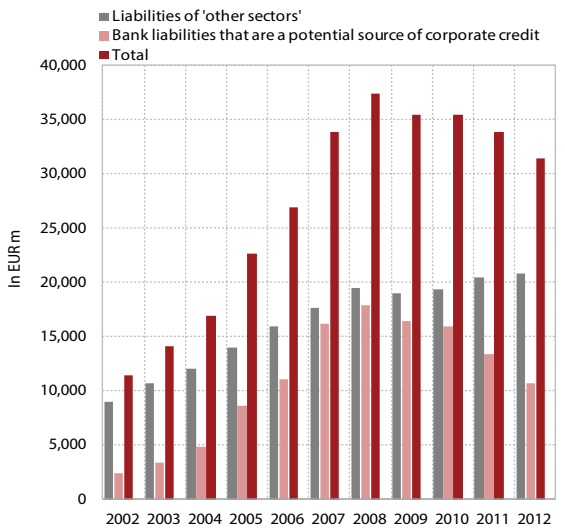
	2002	2005	2007	2008	2009	2010	2011	2012
DIRECT INVESTMENT IN SLOVENIA	9052.6	13974.8	17707.6	19489.4	19028.4	19413.9	20431.5	20808.6
Equity and reinvested earnings	3308.6	5427.9	8547.1	9787.2	9055.9	9401.1	10277.6	10423
Net liabilities to affiliates	2974.2	4901.7	5558	6023.7	5958.3	6094.3	6120.1	6112
PORTFOLIO INVESTMENT	334.4	526.2	2989.1	3763.5	3097.6	3306.8	4157.5	4311
Equity securities	96.4	274.6	1215.6	544.3	849.4	894.4	870.3	885.8
Debt securities (bonds and notes)	74.8	261.3	1209.4	540.5	578.3	644.3	629.9	648.3
TRADE CREDITS	21.6	13.3	6.2	3.8	271.1	250.1	240.4	237.5
LOANS	1730.3	2855.2	3855.5	4018.7	3429.4	3716.1	3868	4112.1
OTHER LIABILITIES	3831.7	5319.5	4057.9	5102.5	5693.7	5402.3	5415.6	5387.7
BANK LIABILITIES THAT ARE A POTENTIAL SOURCE OF CORPORATE CREDIT (total)	85.6	97.6	31.5	36.7	133.6	133.8	155.9	178.2
Debt securities (bonds and notes)	2425	8643	16216.4	17886.5	16414.2	16013.2	13440.5	10656.3
Loans	19.6	336.3	352.7	436.9	2033	2771.7	2450.5	1129.5
Currency and deposits	1633	5929.6	11374.9	12704.7	9740.2	9127	7678.2	6717.2
Other liabilities	662.3	2312.6	4450	4701.3	4621.8	4106.4	3307.6	2805.5
Ostale obveznosti	110.1	64.5	38.8	43.6	19.2	8.1	4.2	4.1
SKUPAJ	11477.6	22617.8	33924	37375.9	35442.6	35427.1	33872	31464.9

Source: Bank of Slovenia, 2013.

[37] Debt securities (bonds and notes), loans, currency and deposits and other liabilities.

and then eased significantly again in 2012 (1.8%). The banks' foreign liabilities that represent a potential source of corporate credit reveal a different picture. After rising rapidly until 2008, they began to slow, suggesting that this potential source of corporate financing is declining. A dramatic fall was seen in 2011 (-16.1%) and particularly in 2012 (-20.7%), when direct foreign corporate financing was already improving slightly. Since 2008 the total (actual and potential) stock of foreign corporate financing has thus been falling solely as a result of a decline in foreign financing reaching firms via bank intermediation, while direct foreign corporate financing has continued to increase, albeit slowly (Figure 31).

Figure 31: **Liabilities of 'other sectors' and bank liabilities that are a potential source of corporate credit in the International Investment Position of Slovenia, 2012–2012, total, EUR m**



Source: Bank of Slovenia, 2013.

The most important foreign source of corporate financing is foreign direct investment (FDI), followed by loans. At the end of 2012 FDI accounted for 50.1% of all foreign financing of 'other sectors'; 29.4% thereof comprised equity and reinvested earnings while 20.7% comprised Slovenian subsidiaries' net liabilities to parent companies arising from intra-company loans. Loans accounted for 25.9% of foreign financing and trade credits for 19.8%. Portfolio investment accounted for merely 4.3%, of which 3.1% comprised equity securities and 1.1% debt securities (Table 2). However, in light of the figures for direct foreign financing via domestic bank intermediation, the dominant form of inflows of foreign financing is certainly loans.

FDI equity has been the most important foreign source of financing of 'other sectors' during the crisis, while net liabilities to affiliates and trade credits have also risen above the pre-crisis level after an initial fall. Liabilities from issued debt securities increased sharply in 2009, i.e. during the crisis, but the increase was one-off and remained modest. Loans and equity securities have recorded the lowest figures during the crisis. They have still not recovered from very rapid and dramatic falls – loans in 2007 and equity securities in 2008 – and are far lower than before the crisis. In 2012 the stock of loans continued to decline, meaning that the corporate sector was making net repayments of loans to foreign creditors. Figures 32 and 33 show the trends in the stock and structure of foreign liabilities of 'other sectors'. The most obvious feature of the flows in Figure 32 is a substantial increase in the stock of liabilities from FDI after 2006. Only to a very small extent was this increase the result of an increase in equity and reinvested earnings; it was primarily the result of an increase in Slovenian subsidiaries' net liabilities to affiliates, i.e. in net liabilities via business-to-business lending at Slovenian subsidiaries. This was primarily due to a methodological change, which extended the statistical monitoring of intra-company loans from parent companies to all firms in a group. The stock of loans plummeted in 2007 and has yet to return to the pre-crisis level. The stocks of trade credits and net liabilities to affiliates declined in 2009 alone, and have already reached their pre-crisis values. The stocks of equity and debt securities remained modest throughout this period; after falling dramatically in 2008, the stock of equity securities remains around half that recorded in 2007, while the stock of debt securities remains unchanged after a substantial increase in 2009 (Figure 32). Despite this divergent movement in individual types of foreign corporate financing (taking into account the impact of the methodological change in monitoring intra-company loans between affiliates within FDI, which has not only raised the proportion accounted for by

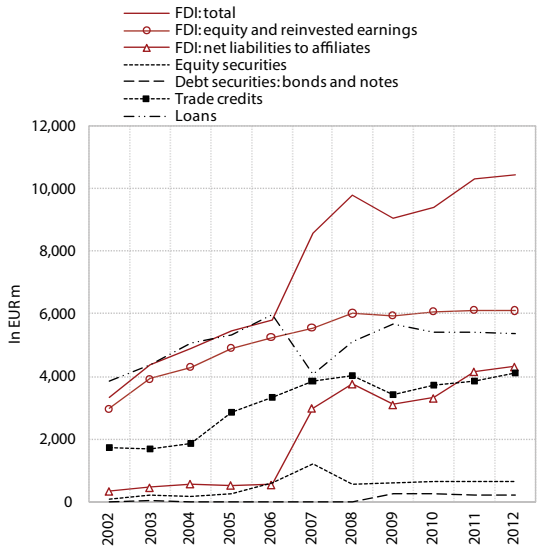
Table 2: **International investment position of Slovenia's 'other sectors': liabilities by variable at the end of 2012**

	EUR m	%
LIABILITIES OF 'OTHER SECTORS': total	20808.6	100.0
DIRECT INVESTMENT IN SLOVENIA	10423	50.1
Equity and reinvested earnings	6112	29.4
Net liabilities to affiliates	4311	20.7
PORTFOLIO INVESTMENT	885.8	4.3
Equity securities	648.3	3.1
Debt securities: bonds and notes	237.5	1.1
TRADE CREDITS	4112.1	19.8
LOANS	5387.7	25.9
OTHER LIABILITIES	178.2	0.9

Source: Bank of Slovenia, 2013.

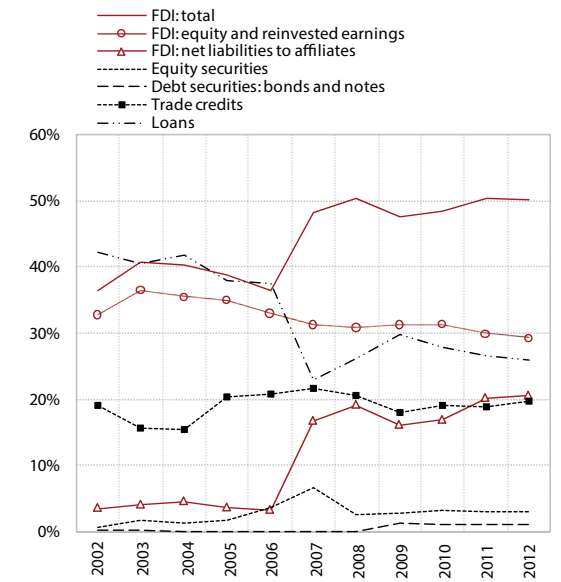
this component, but has also reduced the proportions accounted for by other components), the structure of financing remains relatively stable (Figure 33).

Figure 32: **Stock of liabilities of 'other sectors' in the International Investment Position of Slovenia: liabilities by variable, 2002–2012, EUR m**



Source: Bank of Slovenia, 2013.

Figure 33: **Structure of liabilities of 'other sectors' in the International Investment Position of Slovenia: liabilities by variable, 2002–2012, %**



Source: Bank of Slovenia, 2013.

4. Risk migration between the banking system and the public finances

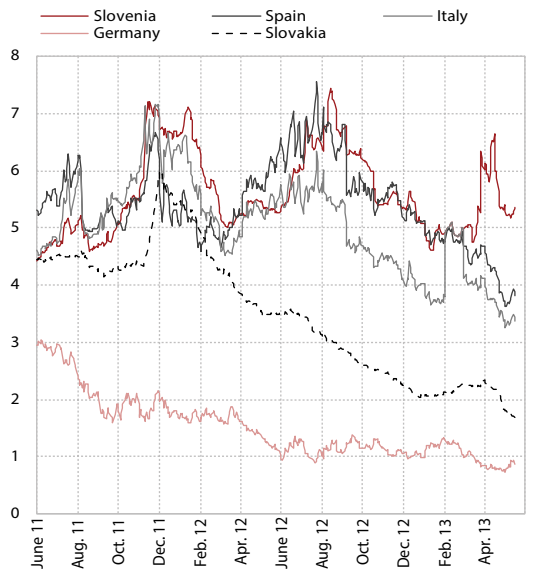
It is assessed that there is a high level of mutual risk migration between the banking system and the public finances. One of the main reasons for Slovenia's sovereign downgrading is the bad shape of its banking system. The bad situation at the banks is impeding lending to the Slovenian economy. This is keeping economic activity low, which is reducing general government revenue and increasing general government expenditure. Recapitalisations of Slovenian banks are a major factor in the widening of the deficit, and are therefore significantly increasing the government borrowing requirement. Access to funding for the government has declined strongly in the last two years. The government again increased its short-term borrowing at domestic banks, which can use government securities as collateral for refinancing operations with the ECB, so that their liquidity remains unaffected. In view of the deteriorating situation, the banks have even become averse to financing clients with higher credit ratings, which given the increasing stock of non-performing claims is additionally raising the share of non-performing claims and is aggravating the situation in the Slovenian banking system. The performance of Slovenian banks is worsening from year to year, which is increasing the pressure on the capital adequacy of the Slovenian banking system and hence the need for fresh capital. The deterioration in bank performance is the result of increased creation of additional impairments and provisions and a sharper fall in net interest income. The latter is attributable to a decline in high-quality clients, which do not fall into arrears on payments of maturing liabilities, and the faster fall in asset interest rates than in liability interest rates.

4.1 Banking sector's impact on the public finances

The bad shape of its banking system makes Slovenia particularly vulnerable on the international financial markets, which tend to react strongly to any deterioration in the euro area. For instance, after the Cyprus bailout at the end of the first quarter, the yields to maturity on Slovenian bonds recorded the largest rises of any euro area country. We estimate that alongside domestic factors this is also a result of the perceptions of foreign investors, who are now paying closer attention to other countries with banking system problems, even though the situation

in Slovenia is quite different to that in Cyprus.[38] Previously, a strong impact on public finances from the banking sector had also been seen in the case of Ireland, where the state of public finances deteriorated dramatically in just one year, entirely as a result of the bad situation in the banking system, Ireland having previously been regarded as a financially sound country, with a fiscal surplus before the international financial crisis.

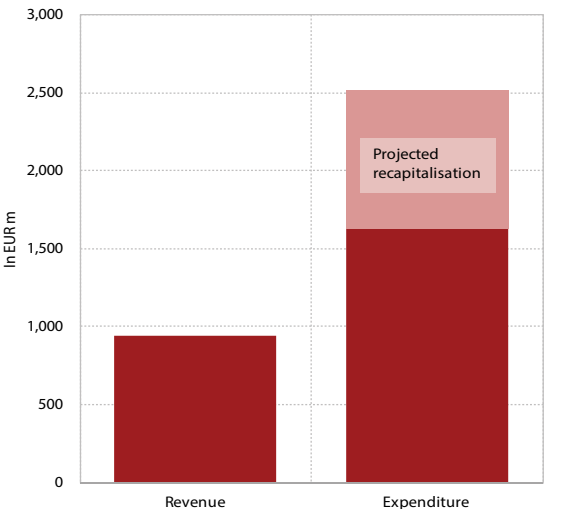
Figure 34: **Yields-to-maturity on government bonds of certain euro area countries**



Source: Bloomberg.

In the absence of other funding, the growing need of the Slovenian banking system for fresh capital is putting pressure on the public finances. Since the outbreak of the financial crisis,[39] the government has spent over EUR 700 m on direct recapitalisations from the budget, not including recapitalisations of state-owned firms. The recapitalisations have nevertheless barely sufficed to satisfy the minimum capital requirements of regulators; capital adequacy has not improved much in this period, and has actually increased less than in the euro area overall (see 2.1.4). In 2011 and 2012 bank recapitalisations contributed 0.7 percentage points and 0.2 percentage points respectively to the widening of the budget deficit relative to GDP, while in 2013 they are projected to contribute 3.7 percentage points. The bank recapitalisations after the transfer of the most toxic assets are projected to significantly exceed the amount spent for improving the capital adequacy of state-owned banks between the outbreak of the financial crisis and the end of the first quarter of this year (approximately EUR 700 m).

Figure 35: **General government revenue and expenditure in connection with bank ownership as of the initial bank restructuring**



Sources: Ministry of Finance; calculations by IMAD.

A comparison of revenue and expenditure related to bank ownership reveals a negative balance from state ownership in the Slovenian banking system. The cash flow from dividend payments has declined significantly during the crisis, and amounted to around EUR 4 m in the period from 2009 to 2011. In the period after the first bank restructuring[40] and before the intensification of the financial crisis, cash flows from dividends were much larger, at over EUR 130 m; this is however still a fairly modest return in our assessment, especially if it is taken into account that the first bank restructuring cost around EUR 850 m (DEM 1.6 bn), which means that the total fiscal impact amounted to between EUR 1.5 bn and EUR 2 bn.

The bad shape of the Slovenian banking system is worsening the situation in the Slovenian economy, which is also being reflected in the calling of

[38] The Slovenian banking system is much smaller than that of Cyprus (in terms of both the absolute level of the banks' total assets, and, in particular, the ratio of total assets to GDP). Its structure is also quite different.

[39] After the collapse of Lehman Brothers.

[40] After the approval of the articles of association and the establishment of the governing bodies, the Bank of Slovenia issued a decree implementing the decree on the completion of the restructuring process at the two banks on 22 July 1997. The completion of restructuring brought an end to the special status of the two banks, and put them on the same footing as other commercial banks, meaning that the banks have to follow the same principles of safe and sound banking operations as all other banks (Hafner, 2013).

guarantees provided on the basis of laws[41] adopted to mitigate the financial crisis. On the basis of these laws the government issued around EUR 2.5 bn in guarantees (almost 90% of which were guarantees to banks) and received just over EUR 60 m in commissions. Between 2009 and 2012 EUR 47 m of guarantees were called, which is, according to our assessment, 15% of all guarantees provided to non-banking subjects.

4.2 Importance of bank restructuring for the Slovenian economy

The Slovenian economy is primarily financed through the banking system. This is a consequence of the nature of the Slovenian economy, and the prevalence of SMEs, which do not have access to the capital market or for which acquiring financing on the capital markets is not economically viable because of high costs. It is assessed that the banks will therefore remain one of the main sources of financing for the Slovenian economy. It is therefore urgent to restore the soundness of the banking system as soon as possible to provide for a more normal financing of the Slovenian economy, and to prevent the further spread of the adverse effects of the crisis through the banking system to the economy.

Other segments of the financial sector are poorly developed, as a result of which bank financing is also a relatively important source of funding for large enterprises, for which financing via the capital market would be sensible, were the capital market not shallow and illiquid. The institutions of this segment are also relatively insignificant. The banking sector accounts for as much as 77.3% of the financial assets of the Slovenian financial system,[42] while the financial assets of other financial intermediaries account for a lower proportion than in the euro area overall.

The transfer of bad claims from the Slovenian banking system to a bad bank addresses two major problems faced by Slovenia: the large share of bad claims in the banking system and the over-leveraging of the Slovenian economy. It directly reduces both the stock and the share of bad claims in the Slovenian banking sector, which have been rising since the second half of 2008. The transfer of claims to a bad bank would, should they be converted into equity, reduce the indebtedness of those firms whose debts were transferred to the bad bank. Firms with lower leverage would thus be under less liquidity pressure and could devote more energy to their core business, thus becoming more attractive to potential investors.

Once the banks have been relieved of major risks, it will also be easier to determine the quantity of capital needed to ensure their capital adequacy in the longer term. This would facilitate a more normal functioning of the Slovenian banking system, which would then be able to finance those firms that are not over-leveraged and have business opportunities. In previous years the problems of the Slovenian banking system were dealt with solely by recapitalisations, most of which were intended only to satisfy the minimum capital adequacy or the requirements of the regulator. However, the minimum amount of capital did not allow banks to take up new risks, where economically viable lending could have contributed to an increase in the stock of higher-quality claims, reducing the problem of bad claims in relative terms. However, until the adoption of the Act Determining the Measures of the Republic of Slovenia to Strengthen Bank Stability (Official Gazette of the Republic of Slovenia, No. 105/12), little was done to improve the management of bad claims in the banking sector and to reduce the stock of bad claims. The impact of the law is likely to be discernible even in the second half of this year, when the situation in the banking system is expected to stop deteriorating and perhaps to start improving gradually.

[41] Public Finance Act (ZJF-D; Official Gazette of the Republic of Slovenia, No. 109/2008), Republic of Slovenia Guarantee Scheme Act (ZJShemRS; Official Gazette of the Republic of Slovenia, Nos. 33/09 and 42/09), Act on the Natural Persons Guarantee Scheme of the Republic of Slovenia (Official Gazette of the Republic of Slovenia, No. 59/09).

[42] Excluding the central bank, the euro area average (excluding Germany, Ireland and Slovakia) is 55%.

5. Challenges

Alongside other structural reforms, restoring the soundness of the banking system is the key to the recovery of the Slovenian economy. An effective and transparent restructuring of the banking system would contain risk migration between the Slovenian banking system and the public finances. A successful bank restructuring is essential to halting the deterioration in the Slovenian banking system and obviating the constant need for bank recapitalisations. After a one-off increase in general government expenditure, this will relieve the pressure on the public finances and on state-owned firms, which used to participate in recapitalisations in the past. A successful bank restructuring is also a prerequisite for easing the pressure from international financial markets, which would in turn improve access to funding.

Once they have clean balance sheets and sufficient capital adequacy, the banks will be able to take up new risks. Better access to bank financing will improve the business conditions for firms with sound financial structure and good business opportunities. A rise in the number of creditworthy clients will also ease the downward pressure on the quality of the banks' assets.

To improve the efficiency of the economy, it is necessary to reduce the government's ownership role, and to put in place an ownership structure that will facilitate corporate development and improve corporate governance. State ownership, which is still significant in the Slovenian economy, has proved to be less than optimal in our assessment. As a result of the ineffective governance of state-owned firms in the past, in most cases state ownership only places an extra burden on the public finances. Under the current circumstances, the best solution would be to find strategic private investors for firms for which there is actual demand at the appropriate price. In this way the government could also improve its credibility for further privatisation processes.

To improve the financial structure of firms in Slovenia, it is also necessary to ensure the proper functioning of other segments of financial services, which primarily rely on longer-term funding. Large, more financially stable firms could thus also seek financing under more favourable conditions on other financial markets. Furthermore, the crowding out of SMEs from bank financing would also be reduced, and these firms could, to a certain extent, also take advantage of better access to long-term financing.

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Annexes

Definition of indicators used in the analysis of indebtedness and financial structure of Slovenian enterprises and the values of selected indicators

Share of debt in total liabilities = $\sum_{i=1}^{n}$ (Provisions and long-term accrued costs and deferred revenues (aop72) + Long-term liabilities (aop75) + Short-term liabilities (aop85) + Short-term accrued costs (expenses) and deferred payments (aop95)) / $\sum_{i=1}^{n}$ (Liabilities (aop55)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of debt relative to capital = $\sum_{i=1}^{n}$ (Provisions and long-term accrued costs and deferred revenues (aop72) + Long-term liabilities (aop75) + Short-term liabilities (aop85) + Short-term accrued costs (expenses) and deferred payments (aop95)) / $\sum_{i=1}^{n}$ (Equity capital (aop56)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of debt relative to EBITDA = $\sum_{i=1}^{n}$ (Provisions and long-term accrued costs and deferred revenues (aop72) + Long-term liabilities (aop75) + Short-term liabilities (aop85) + Short-term accrued costs (expenses) and deferred payments (aop95)) / $\sum_{i=1}^{n}$ (Operating profit (aop151) - Operating loss (aop152) + Depreciation (aop145)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Net sales on the domestic market = $\sum_{i=1}^{n}$ (aop110), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Financial liabilities to banks = $\sum_{i=1}^{n}$ (Long-term financial liabilities to banks (aop78) + Short-term financial liabilities to banks (aop89)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Accounts payable to suppliers = $\sum_{i=1}^{n}$ (Long-term accounts payable to suppliers (aop82) + Short-term accounts payable to suppliers (aop93)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of bank loans in total liabilities = $\sum_{i=1}^{n}$ (Long-term financial liabilities to banks (aop78) + Short-term financial liabilities to banks (aop89)) / $\sum_{i=1}^{n}$ (Liabilities (aop55)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of accounts payable to suppliers in total liabilities = $\sum_{i=1}^{n}$ (Long-term accounts payable to suppliers (aop82) + Short-term accounts payable to suppliers (aop93)) / $\sum_{i=1}^{n}$ (Liabilities (aop55)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Return on assets = $\sum_{i=1}^{n}$ (Net profit for the period (aop186) - Net loss for the period (aop187)) / $\sum_{i=1}^{n}$ (Liabilities (aop55)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Value added = $\sum_{i=1}^{n}$ (Gross operating returns (aop126) - Costs of merchandise, material and services (aop128) - Other operating expenses (aop148)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of financial expenses from financial liabilities relative to net sales =$\sum_{i=1}^{n}$ (Financial expenses from financial liabilities (aop169)) / $\sum_{i=1}^{n}$ (Net sales (aop110)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of financial expenses attributable loans received from banks relative to net sales = $\sum_{i=1}^{n}$ (Financial expenses attributable to loans received from banks (aop171)) /$\sum_{i=1}^{n}$ (Net sales (aop110)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of financial expenses attributable to loans received from companies in the group relative to net sales = $\sum_{i=1}^{n}$ (Financial expenses attributable to loans received from companies in the group (aop170)) / $\sum_{i=1}^{n}$ (Net sales (aop110)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of financial expenses attributable to issued bonds relative to net sales = $\sum_{i=1}^{n}$ (Financial expenses attributable to issued bonds (aop172)) / $\sum_{i=1}^{n}$ (Net sales (aop110)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of financial expenses from other financial liabilities relative to net sales = $\sum_{i=1}^{n}$ (Financial expenses from other financial liabilities (aop173)) / $\sum_{i=1}^{n}$ (Net sales (aop110)), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Financial expenses attributable to loans received from banks = $\sum_{i=1}^{n}$ (aop171), where i=1, 2,…n and n is the total number of enterprises covered by the sample.

Share of long-term financial liabilities to banks relative to total liabilities = $\sum_{i=1}^{n}$ (Long-term financial liabilities to banks (aop78)) / $\sum_{i=1}^{n}$ (Liabilities (aop55)); where i=1,2,…n and n is the total number of enterprises covered by the sample.

Share of short-term financial liabilities to banks relative to total liabilities = $\sum_{i=1}^{n}$ (Short-term financial liabilities to banks (aop89)) / $\sum_{i=1}^{n}$ (Liabilities (aop55)); where i=1,2,…n and n is the total number of enterprises covered by the sample.

Net sales on foreign markets = $\sum_{i=1}^{n}$ (Net sales on the EU market (aop115) + Net sales outside the EU market (aop118)), where i=1, 2,…n and n is total the number of enterprises covered by the sample.

Table P1: **Selected indicators by different activities of private sector enterprises, 2006–2011**

		Share of revenues (in %)		Growth (in %)	
		Financial expenses from loans	Financial expenses from bank loans	Financial expenses from bank loans	Sales revenues
Manufacturing	2006	1.3	1		12.1
	2007	1.5	1.2	40.3	14.2
	2008	2.2	1.7	45.3	1.1
	2009	2.2	1.7	-23.4	-20.7
	2010	2.1	1.5	0.6	11.1
	2011	1.8	1.5	4.8	5.6
Construction	2006	1.2	1		15.1
	2007	1.3	1.1	49.8	44.2
	2008	1.9	1.5	62	12.5
	2009	2.4	1.8	-3.6	-20.1
	2010	2.8	2.2	4.6	-13.6
	2011	2.7	2.4	-12.8	-19.2
Wholesale and retail trade	2006	1.1	0.8		6.9
	2007	1.3	1	34.8	8.9
	2008	1.8	1.3	52.7	12.3
	2009	1.6	1.2	-23.8	-13.8
	2010	1.7	1.2	-1.3	-2.3
	2011	1.6	1.1	-5.4	1.6
Financial intermediation	2006	68.6	46.4		31.6
	2007	100.9	78.2	130.9	37
	2008	145.2	112.9	82.1	26.2
	2009	85.7	62	-55.7	-19.3
	2010	95.4	75.5	31.7	8.1
	2011	78.8	58.4	-23.9	-1.6
Real estate	2006	3.7	2.3		7.8
	2007	5.6	3.5	95.5	30.4
	2008	7.1	4.7	56.8	15.8
	2009	7.5	4.4	-15.8	-8.8
	2010	6.2	4	-2.3	7.9
		6.3	4.2	1.9	-4.6

Source: AJPES; calculations by IMAD.

Table P2: **Selected indicators by different activities of private sector enterprises, 2007–2011**

		C	D	E	F	G	H	I	J	K
2007	Sales revenues	12.1	14.2	4.5	44.2	8.9	31.3	14.5	37	30.4
	Value added	4.9	12.2	2.8	26.1	10.4	18.2	13.5	68.9	27.3
	ROA	2.2	4.1	1.7	3.4	3.9	1.3	4.8	2.8	3.1
	Bank loans to total liabilities	16.5	24.6	10.2	27	30.3	28.2	22.6	75.4	39.9
	Long-term bank loans to total liabilities	7.5	11.1	7.7	8.5	15.2	21.9	14.8	60.6	20.3
	Short-term bank loans to total liabilities	9	13.5	2.5	18.5	15.1	6.3	7.8	14.8	19.6
2008	Sales revenues	13.1	1.1	8.7	12.5	12.3	9.3	3.6	26.2	15.8
	Value added	1.3	1.2	0.5	18	8.7	5.4	1.7	4.2	16.5
	ROA	-1	2.3	1.4	2.3	1.5	-1.5	2.7	0.6	1.7
	Bank loans to total liabilities	19.9	27.8	12.3	28.3	33.2	33	26.3	75.4	41.6
	Long-term bank loans to total liabilities	9.1	11.9	9.4	7.1	14.4	23.5	15.9	59.5	20.2
	Short-term bank loans to total liabilities	10.8	15.9	2.9	21.2	18.8	9.5	10.4	15.8	21.4
2009	Sales revenues	-6.4	-20.7	12	-20.1	-13.8	-2.2	-14	-19.3	-8.8
	Value added	2.7	-14.8	-3.1	-14.5	-3.9	-1.1	-12.8	-21.5	12.1
	ROA	0.2	0.02	0.9	-0.2	1.5	-1.5	-1	-0.7	0.8
	Bank loans to total liabilities	23.1	28.6	12.6	30.9	31	33.8	25.7	75.6	39.6
	Long-term bank loans to total liabilities	12.4	13.6	9.6	9.9	13.3	23.7	17.7	54.8	19.9
	Short-term bank loans to total liabilities	10.7	15	3	21	17.7	10.1	8	20.8	19.7
2010	Sales revenues	6.6	11.1	3.3	-13.6	-2.3	-2.7	5.6	8.1	7.9
	Value added	-2.6	5.4	9.2	-22.3	-5.4	-3.8	2.2	3.1	-7.5
	ROA	0.7	1.3	1.7	-4.3	-0.3	-2.4	-5.7	-1.2	0.2
	Bank loans to total liabilities	23	28.6	15.8	34.6	33	35.1	27.1	74.9	38.8
	Long-term bank loans to total liabilities	12.8	14.2	11.8	11.4	14.6	24.9	17.8	55.9	22.2
	Short-term bank loans to total liabilities	10.2	14.4	4	23.2	18.4	10.2	9.3	19	16.6
2011	Sales revenues	0.2	5.6	4.8	-19.2	1.6	5.3	-4.1	-1.6	-4.6
	Value added	-0.01	1.1	11.7	-13.7	-4	2.8	-8.5	2.4	-1.4
	ROA	-0.1	1.9	1.5	-3.3	1.2	-3.3	-0.6	-1.5	-0.4
	Bank loans to total liabilities	24.5	27.9	18.2	35.6	33.6	36	25.9	74.4	37.9
	Long-term bank loans to total liabilities	15.2	13.7	14.9	12.2	18.5	22.1	15.7	55.3	21.8
	Short-term bank loans to total liabilities	9.3	13.5	3.3	23.4	15.1	13.9	10.2	19.1	16.1

Source: AJPES; calculations by IMAD. Note: SCA2002: A&B: Agriculture–fishing; C: Mining; D: Manufacturing; E: Electricity, gas, steam and air conditioning supply; F: Construction; G: Wholesale and retail trade, repair of motor vehicles and motorcycles; H: Accommodation and food service activities; I: Transportation and storage; J: Financial intermediation; K: Real estate activities, rental and leasing activities.

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