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I. Fiscal developments and fiscal policy

Summary

In the 2005–2008 period Slovenia had achieved high rates of economic growth, but during the economic crisis it registered one of the sharpest slowdowns of economic activity among EU Member States, as well as one of the most severe deteriorations of public finances. Rigidity of expenditure and a high structural deficit during the peak of the economic cycle exacerbated the weakness of public finances during the crisis. The general government deficit had been contracting before the crisis, and in 2007 Slovenia had a balanced general government position. However, these trends were driven by the economic cycle, as Slovenia had recorded a structural deficit throughout the period preceding the crisis, and the deficit only widened further between 2006 and 2008. In 2006 and 2007, tax reform put in place a series of tax changes that had a significant and lasting impact on general government revenue, but there was no matching permanent reduction in expenditure. Indeed, expenditure continued to rise until 2011.

The belated, and insufficient, response to the crisis in its initial stages has now increased pressure on fiscal policy, which is pursuing the objective of bringing the deficit below 3% of GDP by 2015. The deficit having risen sharply in 2009 on the back of an increase in expenditure and decline in revenue, fiscal policy in subsequent years focused on restraining growth in spending. But given that revenue grew at a sluggish pace, the deficit remained high, at around 6% of GDP. It was not until 2012 that overall general government expenditure dropped on the back of a contraction of all expenditure categories (except interest payments), leading to the first significant narrowing of the deficit since the start of the crisis. In 2011 and 2012, when the corporate income tax rates were cut, certain measures to raise additional revenue were adopted. In 2013, meanwhile, additional increases of tax rates and measures to curtail the grey economy further increased the importance of revenue-side measures in the fiscal consolidation drive; revenue thus exceeded the 2008 level for the first time. The gap between revenue and expenditure has nevertheless been narrowing slowly, to a significant extent due to one-off factors associated with the recapitalisation of banks and certain state-owned companies. The growing debt and interest payments associated with high deficits and one-off factors, coupled with the expansion of certain social protection expenditure (pensions, healthcare) which account for the bulk of the increase in overall expenditure since the beginning of the crisis, are thus increasingly limiting the scope of fiscal policy action, as there are few prospects for tax increases given Slovenia's ranking in international taxation standings.

Fiscal consolidation stalled last year. After a significant drop in 2012, to 4.0% of GDP, the deficit widened to a record 14.7% of GDP in 2013. The bulk of the deficit, 10.3% of GDP, was associated with expenditure earmarked for strengthening the capital adequacy of the banking system. One-off expenditure excluded, the deficit (3.7% of GDP) was at a similar level to that of 2012. The improvement in the structural position of the general government balance was also smaller than in 2012. Consolidation thus stalled last year as interest expenditure rose and pension expenditure ticked up due to accelerated retirement preceding the implementation of the pension reform; the adopted measures - increased VAT rates, measures to curb the grey economy and an agreement to additionally lower wages and other labour costs – were not sufficient to produce any significant deficit reduction. Expenditure on goods and services and certain social transfers continued to drop, whereas the scaling back of subsidies stalled. Buoyed by increased receipts of EU funds, gross capital formation also rose following two years of decline.

Last year's increase of the general government debt was the steepest to date and in the period since the start of the crisis Slovenia has gone fairly quickly from the group of countries with low debt to the group of countries with medium indebtedness. The general government debt reached EUR 25.3 bn in 2013 or 71.7% of GDP, having increased by EUR 6.1 bn or 17.3 p.p. in the last year alone. More than half of last year's debt increase is a consequence of bank recapitalisation and the issuing of a bond for the Bank Assets Management Company (BAMC). Slovenia's debt increase in the past five years, amounting to almost 50 p.p., was the sixth largest among the EU Member States. Together with the fiscal effort required to reduce the deficit, the pace of the debt increase and hence interest payments creates strong pressure on the structure of expenditure.

Fiscal consolidation continued in the majority of EU Member States last year. Having already exceeded 6% of GDP in 2009 and 2010, the general government deficit in the euro area and in the EU was more than halved by 2013: it stood at 3.0% of GDP in the euro area and 3.3% of GDP in the EU. With the fiscal picture gradually improving, some EU countries have already exited EU financial aid mechanisms, though they remain subject to surveillance. Government measures to stabilise public finances, coupled with measures executed and announced by the ECB, have also substantially reduced the spread of yields on euro area bonds since last autumn. This year the average general government debt in the euro area and in the EU is projected to drop below 3% of GDP according to the

spring forecast of the European Commission. Taking into account the projected improvement, 12 EU Member States will remain subject to excessive deficit procedure after 2014. In accordance with the reformed procedures as part of the enhanced coordination of fiscal policies, the EC started implementing substantive surveillance of budgeting in several euro area countries in the autumn of 2013.

Under Slovenia's Stability Programme – Update 2014, the pace of deficit cutting is in line with the EU Council recommendations. The SP2014 pursues the objective of Slovenia reducing the general government deficit to 3.2% of GDP this year and 2.4% of GDP in 2015, one-off expenditure excluded. Considering that bank recapitalisation is planned to amount to 0.9% of GDP, this year's deficit will stand at 4.1% of GDP. The planned consolidation is also expected to result in a reduction of the structural deficit by 0.6% of GDP in 2014 and 0.5% of GDP in 2015. The deficit-reduction policy mix focuses on three areas in SP2014: revenue growth, maintaining expenditure at the 2013 level over the medium term, and reduction of the debt in 2016–2017 with privatisation proceeds, which will contribute to a stabilisation of interest expenditure towards the end of the programming period.

The revenue growth planned in the SP2014 is based on relatively higher tax revenue compared to other general government revenue, which is largely a consequence of already adopted or planned discretionary measures. The tax revenue projections are nevertheless significantly lower than in the SP2013, largely due to the shortfall of proceeds from real estate tax due to the repealing of its legal basis by the Constitutional Court, the abandoning of the idea of a crisis tax, and partially due to the projected slower economic recovery. To a certain extent the SP2014 replaces the shortfall of this tax revenue with other, non-tax revenue. Consequently, consolidation is underpinned to a greater extent than in the SP2013 by higher non-tax revenue, which constitutes a risk since the measures to increase such revenue are only vaguely outlined in the SP2014. A portion of the planned measures to raise more revenue (some applicable in 2014) also requires legislative changes which could be delayed due to the early general election. The real estate and crisis taxes having been abandoned (notwithstanding the appropriateness of these measures), the SP2014, unlike the SP2013, assumes various one-off revenues (sale of concessions, corporate profits, certain extraordinary non-tax revenue) that does not constitute a systemic fiscal source which would address the long-term fiscal challenges; the proceeds from these sources are also less reliable than tax sources. In this respect, the stated goal in the SP2014 that the real estate tax be promulgated once again after the contested provisions are improved, appears to be an appropriate measure.

The significant increase in interest expenditure is weighing heavily on fiscal consolidation in the SP2014. The consolidation strategy under the SP2014 assumes a decrease of primary expenditure after 2014, to the extent that the surge in interest in 2014 is entirely absorbed up to 2018. In addition to growth of interest expenditure, brisk expansion of investments is planned in 2014 (partially associated with EU funds), whereupon investments are projected to drop to the 2013 level by 2018. Throughout the entire period only expenditure on social transfers and benefits is increasing, a result of the growth in pension and healthcare expenditure. Expenditure on interest and social benefits, which already accounted for the biggest share of the increase in overall expenditure in the 2008–2013 period (excluding recapitalisation of banks and state-owned companies), will thus remain the fastest growing segment of expenditure in the next five-year period. Fiscal policy action therefore remains largely focused on expenditure categories that have already seen the deepest cuts, which includes subsidies, investments, labour costs and intermediary consumption expenditure. The SP2014 projects a more restrictive policy for this type of expenditure than the SP2013. To a significant extent the implementation of the planned measures (some in 2014) to achieve expenditure targets under the SP 2014 is conditional on legislative changes that are yet to be implemented, whereas some measures are yet to be defined.

The strategy of fiscal consolidation in the SP2014 also envisages debt reduction, which decreases projected interest payments; this strategy relies on the privatisation of state-owned companies. For this year and next the SP2014 assumes further debt growth, peaking at 81.1% of GDP in 2015, whereupon debt is projected to decline. The debt reduction under the SP2014 (EUR 1.5 bn) implicitly indicates that privatisation proceeds will be used to pay down debt. The projected debt reduction is feasible given that the National Assembly has approved the sale of 15 companies whose value is estimated at around EUR 1.3 bn. Nevertheless, the plan's feasibility hinges on the pace of privatisation, which had been delayed or abandoned in the past due to problems in achieving political consensus. The state will furthermore receive the proceeds of bank assets which will be sold by the BAMC. In order for these processes to proceed smoothly, it is paramount that the Slovenian State Holding, the manager of state assets established this year, as well as the BAMC, are fully operational. There has been no decision as yet on the joint management of capital assets held by the SSH and the BAMC, though this will be vital given that the two institutions manage and dispose of stakes in the same companies.

Slovenia can achieve the stated objectives through the consolidation strategy defined in the SP2014, though this will require the timely adoption of measures planned in the SP2014 as well as additional measures. Fiscal policy remains committed to the goal of reducing the deficit below 3% of GDP in 2015. Given that the approach to consolidation has been inadequate in that it is not underpinned by the timely adoption of measures with lasting effects, there are downside risks to achieving the objective. In the short term the main challenge will be to adopt measures which will secure the implementation of the consolidation plan in 2014 and 2015. Given that some revenue- and expenditure-side measures have not been defined, there is a risk that the level of investments projected for individual years will not be realized. In 2014, for example, the planned investment growth outpaces the planned inflow of EU funds, which means that to a certain degree the projections of investments create some leeway for the reduction of this type of expenditure in the event that there are problems in achieving the planned level of other expenditure or revenue, and hence the target deficit.

In the short and long term, fiscal policy faces the challenge of crafting measures with more lasting effects. Owing to the slow recovery and the limited scope to raise taxes, fiscal policy is confronted with the need to proceed with consolidation by lowering expenditure and adjusting it to the capacity of the economy. In doing so, it will have to focus to a greater extent than previously on achieving consensus on measures with a more lasting effect, which will also be a result of a substantive debate about the financing of social priorities. The gradual correction of the deficit and the production of a surplus in the medium term will also stem the growth of public debt, though it will be a great challenge to reduce it as planned with proceeds from the privatisation of state-owned companies. However, this would contribute not only to consolidation and debt sustainability, and reduce the crowding out of other expenditure categories that could be leveraged to promote economic growth, it could also indirectly affect overall economic activity by improving corporate governance and reducing fiscal risks. In the long run, fiscal risks and challenges will stem primarily from the projected population ageing and the attendant adjustment of the systems of pension insurance, health care and long-term care. The biggest risk to the sustainability of public finances is the rapid growth of pension expenditure. The problem of covering pension expenditure is already pertinent and in recent years has required increasing transfers from the national budget; after 2020, it will only get worse. Studies also show that current health care and long-term care policies are unsustainable. In recent years health expenditure has been curbed chiefly through austerity measures such as the slowing of wage growth, lowering of drug prices and deferral of investments, but such measures cannot be sustainable in the long term. In health care the challenge will therefore be to put in place long-term systemic changes, but these need to be enacted concurrently with the establishment of a system of long-term care and changes to the pension system.

Introduction

With consolidation coming to a halt in 2013, fiscal and other policies face the challenge of further reducing the deficit and honouring Slovenia's commitments in the framework of the excessive deficit procedure. In the short term, fiscal policy is committed to reducing the deficit below 3% of GDP by 2015; in the medium and long term, it seeks to balance public finances and mitigate pressure on age-related expenditure. Fiscal consolidation will continue against the backdrop of weak economic recovery. Given the modest projected expenditure growth, the challenge for fiscal policy will be to restructure expenditure and manage the rising level of public debt, as interest expenditure is increasingly crowding out other types of expenditure.

The fiscal section of this year's Economic Issues focuses on analysing the state of public finances and assessing the planned fiscal consolidation as determined in the Stability Programme (Update 2014). The first chapter outlines the trends in public finances in the EU in 2013, while the subsequent chapter presents an analysis of fiscal trends and fiscal policy action in Slovenia since the beginning of the economic crisis. Chapters three and four form the core of the fiscal section, which is dedicated to an analysis and critical evaluation of plans to reduce the deficit and debt as planned in this year's Stability Programme. This is followed by a chapter laying out the latest demographic projections by Eurostat and age-related analyses that highlight the need for changes in social protection systems targeted at mitigating the risks to the long-term sustainability of public finances. On the basis of the analysis, the conclusion singles out the key challenges for fiscal policy as regards the sustainable achievement of the objectives in the short and long term.

1 Fiscal developments and fiscal policy in the EU

Fiscal consolidation in the majority of EU Member States continues after deficits were significantly reduced post-2010. Having already exceeded 6% of GDP in 2009 and 2010, the general government deficit in the euro area and in the EU had been more than halved by the end of 2013: it averaged 3.0% of GDP in the euro area and 3.3% of GDP in the EU. In 2013 the general government deficits decreased in the majority of Member States. According to EC estimates, the improvement in the balance of public finances was the result of significant fiscal measures given that nominal GDP growth was modest. In the euro area the deficits were reduced principally through higher revenue (chiefly as a result of the expansion of the tax bases and tax rate increases in many countries), while in the EU the contribution of revenue and expenditure was roughly equal.

In 2014 the general government deficit in the euro area and in the EU is projected to average below 3% of GDP and only 12 Member States are expected to remain subject to excessive deficit procedures. In its Spring Forecast, the EC expects a further improvement in the balance of public finances in the euro area and the EU (by 0.5 and 0.7 percentage points, respectively) due to a faster recovery and additional fiscal measures adopted by the individual Member States. For the first time since 2008, the

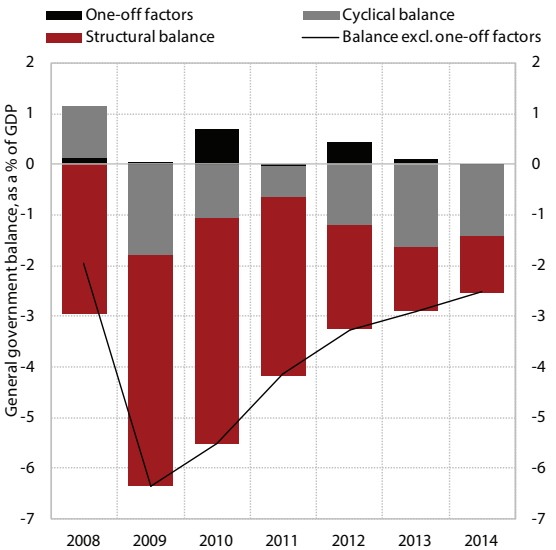
Table 1: **Actual and cyclically adjusted general government balances in EU countries**

	Actual balance (as a % of GDP)						Structural balance (as a % of GDP)					
	2009	2010	2011	2012	2013	2014*	2009	2010	2011	2012	2013	2014*
Belgium	-5.6	-3.8	-3.8	-4.1	-2.6	*-2.6*	-3.9	-3.4	-3.5	-3.0	-2.3	*-2.3*
Germany	-3.1	-4.2	-0.8	0.1	0.0	*0.0*	-0.7	-2.2	-1.0	0.3	0.6	*0.5*
Estonia	-2.0	0.2	1.1	-0.2	-0.2	*-0.5*	-1.0	-0.8	-0.5	0.0	-0.4	*-0.5*
Ireland	-13.7	-30.6	-13.1	-8.2	-7.2	*-4.8*	-9.6	-9.3	-8.4	-7.9	-6.2	*-4.5*
Greece	-15.7	-10.9	-9.6	-8.9	-12.7	*-1.6*	-14.7	-9.1	-6.0	-1.0	2.0	*1.0*
Spain	-11.1	-9.6	-9.6	-10.6	-7.1	*-5.6*	-8.6	-7.1	-6.5	-4.1	-2.8	*-2.4*
France	-7.5	-7.0	-5.2	-4.9	-4.3	*-3.9*	-6.2	-5.9	-4.8	-3.8	-3.0	*-2.3*
Italy	-5.5	-4.5	-3.7	-3.0	-3.0	*-2.6*	-4.2	-3.8	-3.7	-1.5	-0.9	*-0.8*
Cyprus	-6.1	-5.3	-6.3	-6.4	-5.4	*-5.8*	-6.3	-5.6	-6.4	-6.5	-3.5	*-4.0*
Latvia	-9.2	-8.2	-3.5	-1.3	-1.0	*-1.0*	-4.6	-2.9	-1.4	-0.2	-1.0	*-1.4*
Luxembourg	-0.7	-0.8	0.2	0.0	0.1	*-0.2*	1.7	0.4	1.0	1.7	1.4	*0.6*
Malta	-3.7	-3.5	-2.7	-3.3	-2.8	*-2.5*	-3.6	-4.5	-3.3	-3.9	-2.9	*-2.8*
Netherlands	-5.6	-5.1	-4.3	-4.1	-2.5	*-2.8*	-4.2	-4.2	-3.8	-2.7	-1.3	*-1.3*
Austria	-4.1	-4.5	-2.5	-2.6	-1.5	*-2.8*	-2.7	-3.2	-2.2	-1.6	-1.1	*-1.2*
Portugal	-10.2	-9.8	-4.3	-6.4	-4.9	*-4.0*	-8.5	-8.4	-6.1	-3.5	-2.6	*N/A.*
Slovenia*	-6.3	-5.9	-6.4	-4.0	-14.7	*-4.3*	-4.7	-4.9	-5.0	-2.7	-2.5	*-2.5*
Slovakia	-8.0	-7.5	-4.8	-4.5	-2.8	*-2.9*	-7.8	-7.2	-4.8	-3.9	-2.0	*-2.2*
Finland	-2.5	-2.5	-0.7	-1.8	-2.1	*-2.3*	0.5	-1.1	-0.6	-1.0	-0.6	*-0.9*
EMU-18	-6.4	-6.2	-4.1	-3.7	-3.0	*-2.5*	-4.5	-4.4	-3.5	-2.1	-1.3	*-1.1*
Bulgaria	-4.3	-3.1	-2.0	-0.8	-1.5	*-1.9*	-3.6	-2.3	-1.8	-0.6	-1.1	*-1.5*
Czech R.	-5.8	-4.7	-3.2	-4.2	-1.5	*-1.9*	-5.6	-4.6	-3.0	-1.6	-0.1	*-1.1*
Denmark	-2.7	-2.5	-1.9	-3.8	-0.8	*-1.2*	0.2	-0.1	0.3	0.6	0.6	*-0.2*
Croatia	-5.3	-6.4	-7.8	-5.0	-4.9	*-3.8*	-4.9	-5.4	-7.2	-4.1	-3.5	*-3.1*
Lithuania	-9.4	-7.2	-5.5	-3.2	-2.2	*-2.1*	-6.9	-4.7	-4.4	-2.9	-2.1	*-1.9*
Hungary	-4.6	-4.3	4.3	-2.1	-2.2	*-2.9*	-2.3	-3.2	-4.0	-0.8	-0.8	*-2.2*
Poland	-7.5	-7.8	-5.1	-3.9	-4.3	*5.7***	-8.5	-8.4	-5.8	-4.1	-3.8	*-2.8*
Romania	-9.0	-6.8	-5.5	-3.0	-2.3	*-2.2*	-9.6	-6.1	-3.8	-2.5	-1.7	*-1.8*
Sweden	-0.7	0.3	0.2	-0.6	-1.1	*-1.8*	2.7	1.2	0.4	0.3	0.1	*-0.9*
U. Kingdom	-11.4	-10.0	-7.6	-6.1	-5.8	*-5.1*	-8.7	-8.1	-6.0	-6.2	-4.8	*-4.6*
EU-28	-6.9	-6.5	-4.4	-3.9	-3.3	*-2.6*	-5.0	-4.8	-3.8	-2.6	-1.8	*-1.7*

Source: Eurostat, EC Spring Forecast 2014, Ameco.
Note: * The EC forecast of the actual balance for Slovenia for 2014 differs from the projections in the Stability Programme (Update 2014) (see Chapter 3.4). There are also differences in the projections of the structurally adjusted balance, which are expected given that the calculation hinges on numerous assumptions and forecasts (see Box 1, Chapter 2.1). Consequently, the structurally adjusted balance forecasts of individual institutions vary. ** This year's surplus in Poland is strongly affected by a one-off factor (in accordance with ESA methodology) amounting to 9% of GDP due to the transfer of assets from the second to the first pension pillar.

deficit is projected to drop below 3%, mainly as a result of an improvement in the cyclical component; the structural balance[1], on the other hand, will improve at a significantly slower pace than last year. The projected decline in primary expenditure will, in addition to measures to rationalise spending, also be a result of the expiry of mechanisms providing aid to the financial sector. Taking into account the projected improvement in the balance of public finances in the EU this year, twelve countries will remain subject to excessive deficit procedures beyond 2014, the majority of which need to correct their deficits by 2015 or 2016. The EC Spring Forecast indicates that at least some of them could face problems honouring their commitments.

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



Source: Eurostat, for 2014 the EC Spring Forecast 2014, Ameco.

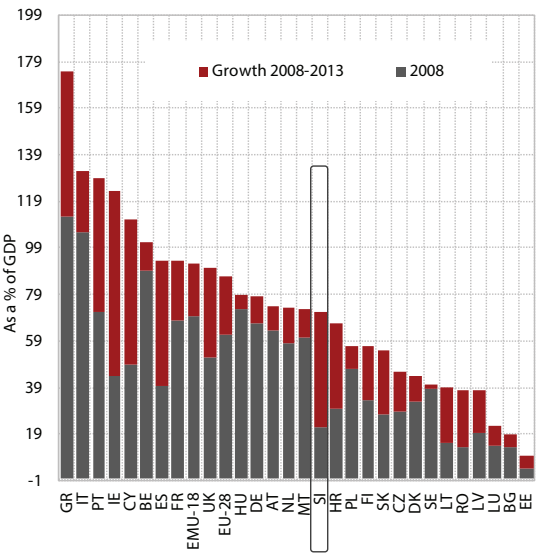
With the fiscal picture gradually improving, some of the most vulnerable EU countries have already exited EU financial aid mechanisms, although they remain subject to surveillance. The implementation of structural reforms and consolidation of public finances last year gradually improved the situation in some vulnerable countries that requested aid from the EFSF and ESM[2] mechanisms, enabling them to return to the international financial markets and issue government bonds as their standing on financial markets improved. Ireland and Spain exited the financial aid mechanisms in December 2013 and Portugal followed in May this year. Nevertheless, they will remain subject to close monitoring by the EC and the ECB.

[1] Actual deficit excluding the effects of the economic cycle and one-off or temporary measures.

[2] Greece, Ireland, Portugal, Cyprus and Spain have so far requested aid (the latter only for bank recapitalisation).

General government debt growth in the euro area and the EU slowed down in recent years after having surged in 2009. Since 2008 the average general government debt rose by 22.5 percentage points in the euro area and by 24.9 percentage points in the EU. In 2013 it exceeded 60% of GDP, the reference debt-to-GDP ratio enshrined in the Stability and Growth Pact, in 16 countries. The bulk of last year's debt increase was a result of the snowball effect[3], in particular regarding interest expenditure (even though it was lower than in the previous years) and the adjustment of flows and balances[4] contributing to debt growth (in particular, support for the banking sector). According to EC forecasts, euro area public debt is expected to rise this year and peak at 96% of GDP as the higher primary surplus, combined with more robust economic growth, will only partially offset the effect of the growing interest expenditure and the adjustment of balances and flows. In 2015 debt will start contracting for the first time since the start of the economic crisis as a result of a higher primary budget surplus and the acceleration of economic growth.

Figure 2: **General government debt increase in EU countries, 2008–2013**



Source: Eurostat.

[3] Increase in debt due to the positive difference between the nominal interest rate and the nominal GDP growth rate.

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

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

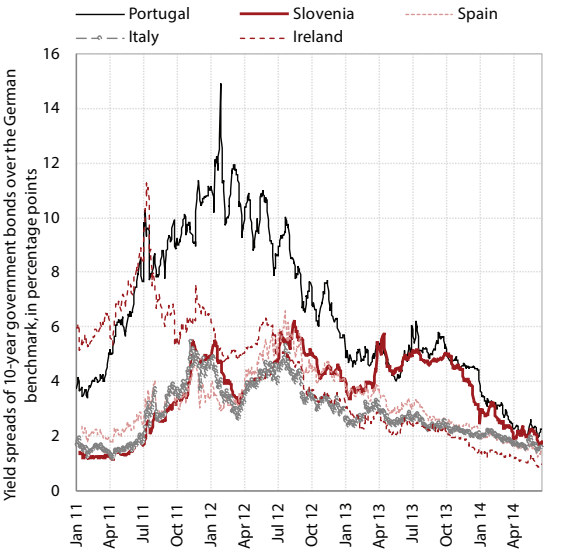
	2009	2010	2011	2012	2013	2014*
Belgium	96.6	96.6	99.2	101.1	101.5	*101.7*
Germany	74.6	82.5	80.0	81.0	78.4	*76.0*
Estonia	7.1	6.7	6.1	9.8	10.1	*9.8*
Ireland	64.4	91.2	104.1	117.4	123.7	*121.0*
Greece	129.7	148.3	170.3	157.2	175.1	*177.2*
Spain	54.0	61.7	70.5	86.0	93.9	*100.2*
France	79.2	82.7	86.2	90.6	93.5	*95.6*
Italy	116.4	119.3	120.7	127.0	132.6	*135.2*
Cyprus	58.5	61.3	71.5	86.6	111.7	*122.2*
Latvia	36.9	44.5	42.0	40.8	38.1	*39.5*
Luxembourg	15.5	19.5	18.7	21.7	23.1	*23.4*
Malta	66.5	66.0	68.8	70.8	73.0	*72.5*
Netherlands	60.8	63.4	65.7	71.3	73.5	*73.8*
Austria	69.2	72.5	73.1	74.4	74.5	*80.3*
Portugal	83.7	94.0	108.2	124.1	129.0	*126.7*
Slovenia	35.2	38.7	47.1	54.4	71.7	*80.4*
Slovakia	35.6	41.0	43.6	52.7	55.4	*56.3*
Finland	43.5	48.8	49.3	53.6	57.0	*59.9*
EMU-18	80.0	85.5	87.4	90.7	92.6	*96.0*
Bulgaria	14.6	16.2	16.3	18.4	18.9	*23.1*
Czech R.	34.6	38.4	41.4	46.2	46.0	*44.4*
Denmark	40.7	42.8	46.4	45.4	44.5	*43.5*
Croatia	36.6	45.0	52.0	55.9	67.1	*69.0*
Lithuania	29.3	37.8	38.3	40.5	39.4	*41.8*
Hungary	79.8	82.2	82.1	79.8	79.2	*80.3*
Poland	50.9	54.9	56.2	55.6	57.0	*49.2*
Romania	23.6	30.5	34.7	38.0	38.4	*39.9*
Sweden	42.6	39.4	38.6	38.3	40.6	*41.6*
U. Kingdom	67.1	78.4	84.3	89.1	90.6	*91.8*
EU-28	74.4	79.9	82.4	85.2	87.1	*89.5*

Source: Eurostat, EC Spring Economic Forecast 2014.
Note: * EC forecast.

The yield spread on euro area government bonds has narrowed significantly since last autumn, to a significant degree due to ECB measures. Until last autumn the yield spread on euro area government bonds had been quite wide, but in November it narrowed significantly chiefly as a result of measures adopted and announced by the ECB[5] as well as due to steps taken by national governments. By June this year the yields dropped further on the back of investors' expectations that the ECB would shortly launch a programme of non-standard measures to mitigate the risk of deflation, and due to deteriorating prospects in emerging-market economies and the retreat to safer investments against the backdrop of the geopolitical tensions in Ukraine. In the first months of this year, the yield spread in vulnerable countries also narrowed slightly, thus remaining much lower than last year.

[5] The purchase of euro area government bonds, the provision of additional liquidity with new long-term refinancing operations, the cessation of the sterilisation of liquidity fuelled by a programme for the purchase of government and private securities.

Figure 3: **Yield spreads of 10-year government bonds over the German benchmark, in percentage points**



Source: Bloomberg, IMAD calculations.

In the last three years important steps were taken towards enhancing the coordination of economic and fiscal policies in the EU[6] and efforts continue to establish an integrated financial framework with the development of a banking union. The EFSF and ESM have been set up to address the financial problems of the Member States. New legislation, the so-called Six-Pack[7], strengthened the Stability and Growth Pact, whereas the Fiscal Compact[8] *inter alia* introduced a balanced budget rule. By the beginning of 2014 fiscal rules had been adopted by 13 of the 18 euro area countries and independent fiscal institutions were established (or had already existed) in 11 countries for monitoring the implementation of the fiscal rules. A decision was also taken to establish a banking union and ensure its efficient functioning.[9] In the second half of this year the Single Supervisory Mechanism for

[6] See also EI, 2012.

[7] A package of six laws (five regulations and one directive) that introduce stricter requirements regarding the budgetary frameworks of Member States and enhanced surveillance of macroeconomic imbalances. In force since December 2012.

[8] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which is binding on all euro area countries (in effect since January 2013). Its aim was to improve fiscal discipline in the euro area by putting in place a balanced budget rule; compliance is monitored at the national level by independent fiscal institutions.

[9] European Council: European Council conclusions on completing EMU. Brussels, 2012. The main pillars of the banking union are a single supervisory mechanism, a single resolution mechanism, a system of deposit guarantees, a single supervision rulebook).

the financial system[10] will become operational; next year it will be supplemented by the Single Resolution Mechanism (a bank bailout fund with a EUR 55 bn budget[11]). The ECB will take on the supervisory role and it will supervise about 130 financial institutions in the euro area accounting for 85% of euro area bank assets[12].

In accordance with the reformed procedures in the framework of enhanced coordination of fiscal policies[13], the European Commission started implementing substantive surveillance of budgetary planning in several euro area countries[14] in the autumn of 2013. All Member States that are not carrying out macroeconomic adjustment programmes in the framework of other procedures were subjected to checks. For the majority of Member States, the EC concluded that their draft budgetary plans were in conformity or largely in conformity with the provisions of the Two Pack, although it found some non-compliance risks for certain countries. For three countries (France, Netherlands, Slovenia), draft budgetary plans were found to be compliant but without any margin for possible slippage, which represents a risk to the successful correction of the excessive deficit. These three countries as well as Malta and Spain also had to submit Economic Partnership Programmes that outline the fiscal structural reforms that should support a lasting correction of their deficits. The EC has concluded that overall the Economic Partnership Programmes show progress with respect to the improvement of national fiscal frameworks, and mixed results with respect to tax reform and substantial reforms to pension and health systems. Nevertheless, it warns that these countries need to support consolidation with additional structural reforms.

[10] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

[11] European Commission. European Parliament and Council back Commission's proposal for a Single Resolution Mechanism: a major step towards completing the banking union. Brussels, 2014.

[12] Source: ECB; http://www.ecb.europa.eu/ssm/html/index.en.html.

[13] Implementation of the 'six pack' in the euro area was detailed by two regulations. The so-called 'two pack', adopted in the first half of 2013, has also provided for substantive surveillance of budgetary planning by the EC.

[14] The reformed procedures determine that the commitments regarding preliminary substantive surveillance of national budgets apply only to euro area countries. Of the euro area countries, surveillance under this procedure was not carried out in Greece, Ireland, Portugal or Cyprus, which are subject to other procedures involving in-depth surveillance (in the framework of the EFSF and the ESM).

2 Public finances in Slovenia

2.1 Public finances in Slovenia since the start of the economic crisis

Due to structural weaknesses, the economic crisis has severely affected the Slovenian economy and disrupted the balances in public finances. In the period characterised by easy access to financing, Slovenia's model of development had not provided for the efficient allocation of funding towards the strengthening of long-term competitiveness factors and improving the economy's resistance to shocks. Rigidity of expenditure and a high structural deficit during the peak of the economic cycle exacerbated the fragility of public finances during the crisis. The general government deficit had been contracting before the crisis and in 2007 Slovenia had a balanced general government position. But these trends were driven by factors inherent to the economic cycle, not appropriate structural changes: a tax reform implemented in 2006 and 2007 involved a series of tax changes (increased general tax credit in the framework of income tax changes; the phasing out of the payroll tax and a reduction in the corporate income tax rate) which in the subsequent years had a significant and lasting effect on general government revenue since the tax measures were not accompanied by measures to offset the shortfall in tax revenue (such as the expansion of tax bases). Also, the tax changes were not coupled with a (permanent) decrease in expenditure, which is largely determined by law. Contrariwise, expenditure even expanded. Prior to the crisis there was growth in investments and spending on social transfers, and in 2008 and 2009, with the implementation of a new public sector wage system and the continued growth in the number of employees, compensation of employees rose sharply; over these years certain social transfers (pensions) also increased in conjunction with the indexation of pensions to wages.

Against the backdrop of the effect of automatic stabilisers and the bailing out of the banking sector and state-owned companies by recapitalisations, such structural weaknesses have led to a pronounced deterioration of public finances in the crisis. The severe downturn in 2009 (a 7.8% real GDP drop) interacted with the effect of automatic stabilisers to severely undermine public finances that year (-6.3% of GDP). Additionally, measures

Table 3: **General government revenue, expenditure and balance according to ESA95, as a % of GDP, Slovenia**

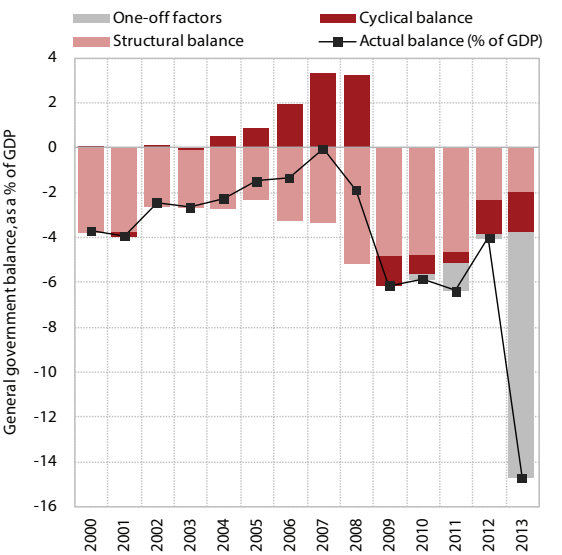
	2008	2009	2010	2011	2012	2013
Revenue	42.2	42.3	43.6	43.5	44.4	44.7
Expenditure	44.1	48.7	49.5	49.9	48.4	59.4
General government balance	-1.9	-6.3	-5.9	-6.4	-4.0	-14.7
Central government	-1.3	-5.4	-5.3	-6.4	-3.8	-14.5
Local government	-0.6	-0.6	-0.3	0.1	0.1	-0.2
Social security funds	0.0	-0.4	-0.4	0.0	-0.3	0.0

Source: SI-STAT Data Portal – National accounts – General government accounts – Main aggregates of the general government, April 2014.
Note: Together with the release of the data for 2013, SURS revised the data for 2008–2012. For 2008 and 2009 only the data on the deficit were revised, while the other aggregates of the general government will be released in autumn 2014 along with a revision of the data in accordance with the new ESA 2000 methodology. The table for 2008 and 2009 therefore states data (the revenue, expenditure and deficit for all levels of government) as published in the SI-STAT database before the revision (March 2014). The deficit for 2008 is the same as it was prior to the revision, and for 2009 it is 6.1%.

were adopted to mitigate the consequences of the crisis. These included measures aimed at improving confidence in financial institutions[15] and a fiscal stimulus to slow down the downturn (measures to preserve jobs, increased spending on R&D; see Development Report 2009, Chapter 1.1). As a result of a breach of the 3% deficit ceiling prescribed by the Stability and Growth Pact, the European Commission launched an excessive deficit procedure against Slovenia in December 2009, obligating it to reduce its deficit below the ceiling level by 2013 (last year the deadline for the correction was extended until 2015). Until 2011 the deficit remained at a high level, about 6%, as consolidation did not start until 2012, when the deficit dropped significantly for the first time since the start of the crisis. In recent years the deficit increased not only due to stimulus measures that drove up the deficit in the early years of the crisis (amounting to approximately 2% of GDP) but also due to the recapitalisation of state-owned companies and banks, and the absorption of the debts of certain companies; such expenditure reached 12% of GDP in 2010–2013.

The structural deficit likewise remained at a high level until 2012. Notwithstanding the changeability of the estimates of the structural balance (see Box 1), all recent estimates show it had already severely deteriorated in the pre-crisis year of 2008. Having hovered at a high level of around 5% of GDP for several years, the structural deficit did not drop significantly until 2012. We estimate that it dropped by an average annual rate of 0.6 percentage points in 2009–2013. The cyclically adjusted balance, which also includes one-off expenditure according to ESA95 methodology, improved significantly in 2012 as well. Last year, however, it surged due to one-off expenditure on bank recapitalisation (10.3 percentage points) and the inclusion of net expenditure on a delayed wage increase in the public sector and the payment of compensation to persons erased from the register of permanent residents (0.7 percentage points combined).

Figure 4: **General government balance, Slovenia**



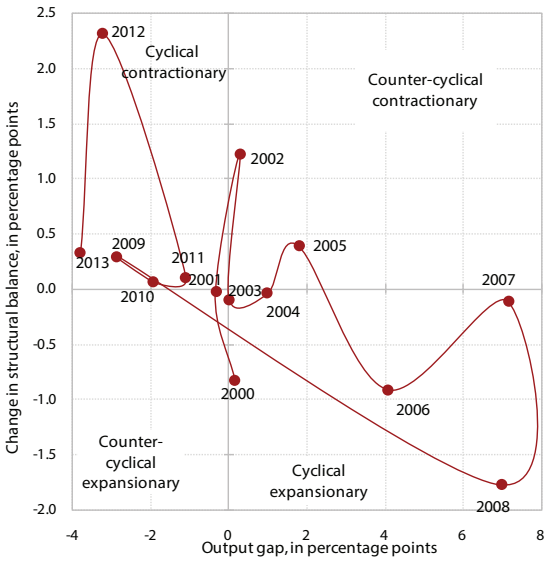
Source: SURS for the actual balance, IMAD calculations for the structural balance.

Since the start of the crisis the fiscal policy stance has been mainly neutral or cyclically contractionary, determined by fiscal limitations associated with Slovenia's commitments under the excessive deficit procedure and limited access to financing. After the severe deterioration of the fiscal balance in 2008, when fiscal policy was explicitly cyclical and expansionary, its action in the next three years was fairly neutral. In

[15] The following measures were adopted: (i) a full deposit guarantee to retail depositors; (ii) treasury operations that provided liquidity when the international credit crunch was most severe and access to financial markets was limited; (iii) state guarantees in favour of financial institutions (guarantees to two commercial banks in the amount of EUR 2 bn) and state guarantee schemes for the corporate sector were granted to enhance the credit flow to the economy. Guarantees to banks for sharing the risk of lending to the real sector were awarded in the amount of EUR 459 m in 2009. To this end, the Slovenian Export and Development Bank (SID) was also recapitalised. Policy interventions concerning the stability of the financial sector and aiming at facilitating the credit flow to the economy had been gradually phased out by the end of 2010.

2012, against the backdrop of a significant decrease in the deficit, fiscal policy was strongly contractionary and acted cyclically given the wider output gap. This fiscal policy stance was determined by fiscal limitations associated with Slovenia's commitments under the excessive deficit procedure and limited access to financing. A substantially different fiscal policy stance was practically impossible in this period.

Figure 5: **The cyclical stance of fiscal policy, taking into account the structural balance**

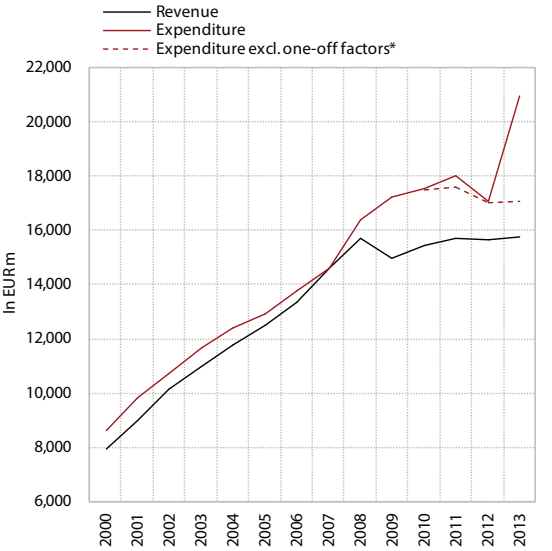


Source: SI-Stat Data Portal – Economy – National accounts – Main aggregates of the general government (SURS), 2014; Spring Forecast of Economic Trends 2014 (IMAD); cyclical components calculated by IMAD.

Since the start of the economic crisis fiscal policy has been defined by the challenge of concurrently stemming the decline in revenue, reducing expenditure, and preserving the quality of public finances. Despite the slowdown in economic activity, overall general government revenue in 2013 was slightly higher than in the year before due to measures to raise additional tax revenue and improvement in the absorption of EU funds, and it exceeded the 2008 level for the first time since the start of the crisis. Nevertheless, tax revenue remains significantly lower than in 2008. On the expenditure side, the decline in primary expenditure (excluding interest expenditure, which rose significantly in 2013) adjusted for one-off events, which did not begin until 2012, slowed down significantly in 2013 as a result of higher spending on pensions and investments. Expenditure thus remains well above the 2008 level and is significantly higher than revenue. The gap between expenditure and revenue, which widened sharply in 2009, is thus narrowing at a slow pace.

The mix of consolidation measures has been changing throughout the crisis, with revenue-side measures lately gaining in importance. With the

Figure 6: **Revenue and expenditure of the general government sector, Slovenia**



Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, April 2014; one-off events: Ministry of Finance.
Note: *Extraordinary expenditure on the recapitalisation of banks and non-financial companies; in 2013 also expenditure on wages due to the elimination of wage disparities in the public sector and the compensation of persons erased from the register of permanent residents.

deficit having risen sharply in 2009 on the back of an increase in expenditure and a decline in revenue, fiscal policy in the subsequent years focused on restraining expenditure growth. But given that revenue grew at a more sluggish pace, the deficit remained high, at around 6% of GDP. Until 2011 expenditure growth had been restrained with non-systemic cuts of the flexible part of expenditure (in particular, investments) and emergency measures that curbed the growth of social transfers (lower indexation) and labour costs in the public sector (primarily wages and other labour costs). In 2011 and 2012, when the corporate income tax was cut, the decline in revenue was also cushioned by increases in excise and other duties, and the introduction of several new duties. In 2012 general government expenditure decreased significantly for the first time since the start of the crisis, as did the deficit (to 4% of GDP). The cuts affected all expenditure categories except for interest expenditure. Over half of the deficit reduction was nevertheless achieved with cuts in the flexible part of expenditure (investments, subsidies, expenditure on goods and services). The measures also relied to a larger extent than in the previous years on structural changes with a more lasting effect. In 2013 consolidation ground to a halt. The deficit, excluding one-off factors, was only 0.1 percentage points lower than in the preceding year, at 3.7% of GDP. Greater emphasis was placed on revenue-side measures; additional measures to curb expenditure were adopted, but they were insufficient to achieve a significant reduction in the deficit (see

Box 1: **The role of structural balance in EU fiscal policy surveillance mechanisms**

The estimate of the structural balance indicates the stance and appropriateness of fiscal policy and it is becoming increasingly important as a component of the enhanced mechanism of fiscal policy surveillance in the euro area. Analysis of the cyclically adjusted and structural balance[1] provides additional insight into past fiscal policy measures. As such, it contributes to the ex post assessment of the fiscal policy stance and helps determine the causes of any imbalances in the past. The structural deficit had already 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 the 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).

Table 4: **Estimates of the structural balance in 2014 and 2013**

	Actual balance (% of GDP)	Cyclical balance	Cyclically adjusted balance	Structural balance	One-off factors	Output gap	Potential GDP growth
2014 estimate							
2000	-3.7	0.1	-3.8	-3.8	0.0	0.2	4.1
2001	-4.0	-0.2	-3.8	-3.8	0.0	-0.3	3.8
2002	-2.4	0.1	-2.6	-2.6	0.0	0.3	3.3
2003	-2.7	0.0	-2.7	-2.7	0.0	0.0	3.3
2004	-2.3	0.5	-2.7	-2.7	0.0	1.0	3.9
2005	-1.5	0.8	-2.3	-2.3	0.0	1.8	3.6
2006	-1.4	1.9	-3.2	-3.2	0.0	4.1	4.1
2007	0.0	3.3	-3.3	-3.3	0.0	7.2	4.1
2008	-1.9	3.2	-5.1	-5.1	0.0	7.0	3.7
2009	-6.1	-1.3	-4.8	-4.8	0.0	-2.9	1.1
2010	-5.9	-0.9	-5.0	-4.8	-0.2	-1.9	-0.1
2011	-6.4	-0.5	-5.9	-4.7	-1.2	-1.1	-0.7
2012	-4.0	-1.5	-2.5	-2.3	-0.2	-3.2	-1.0
2013	-14.7	-1.8	-13.0	-2.0	-10.9	-3.8	-1.2
2013 estimate							
2000	-3.7	0.3	-4.0	-4.0	0.0	0.7	4.1
2001	-4.0	0.0	-4.0	-4.0	0.0	0.0	3.6
2002	-2.4	0.1	-2.6	-2.6	0.0	0.3	3.5
2003	-2.7	-0.1	-2.5	-2.5	0.0	-0.3	3.5
2004	-2.3	0.1	-2.3	-2.3	0.0	0.1	3.9
2005	-1.5	0.4	-1.8	-1.8	0.0	0.8	3.3
2006	-1.4	1.3	-2.7	-2.7	0.0	3.0	3.5
2007	0.0	2.7	-2.8	-2.8	0.0	6.2	3.7
2008	-1.9	2.7	-4.5	-4.5	0.0	6.0	3.5
2009	-6.2	-1.6	-4.6	-4.6	0.0	-3.6	1.4
2010	-5.9	-1.2	-4.7	-4.5	-0.3	-2.7	0.3
2011	-6.4	-0.7	-5.7	-4.4	-1.3	-1.5	-0.6
2012	-4.0	-1.2	-2.8	-2.4	-0.4	-2.8	-1.0
2013	-7.9	-1.5	-6.4	-2.7	-3.7	-3.5	-1.1

Source: SURS for actual deficit, Economic Issues 2013 (IMAD), IMAD calculations.

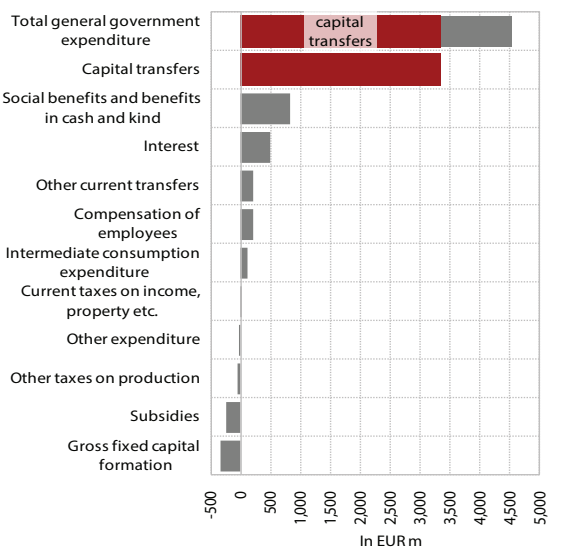
[1] The cyclically adjusted general government balance indicates the fiscal result that would be achieved merely with the effects of fiscal policy – i.e. without the effect of cyclical factors. The structural balance is a cyclically adjusted balance of public finances which does not take into account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

Substantively, the structural deficit is a better indicator of the fiscal balance than the actual deficit, although it should be interpreted cautiously considering the volatility of the estimates; an additional approach to its assessment, which was introduced in November 2013, is therefore welcome. The structural balance 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 stance of fiscal policy and consolidation efforts can be problematic, in particular with regard to decisions for the current and subsequent years and in conjunction with the balanced-budget provisions of the Fiscal Compact. The latter is particularly relevant since a violation of the provision, which the signatory countries must transpose into their national laws with binding force and a permanent character, preferably constitutional[2], 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 (see Table 4). This is a consequence of methodological changes[3] and revised estimates of past economic growth as well as changes in forecasts precipitated by the altered conditions and prospects in the domestic and international environments. Estimates of the structural balance are also affected by ex post revisions of estimates of the general government balance. 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 change the estimate and show that the provision has not been breached (and vice versa). Similarly, fiscal policy may be assessed ex post as counter-cyclical while a subsequent calculation for the same year shows that it was actually cyclical. Analysis of the cyclically adjusted balance and structural balance must therefore be undertaken with utmost caution in the interpretation of the fiscal position as a basis for economic policy making. This is another reason why an additional estimate of the general government balance, one not based on the output gap, is welcome. It is a bottom-up estimate of the fiscal effects of individual measures which the EC first used for Slovenia in the Opinion on the Draft Budgetary Plan, November 2013 (see Chapters 3.1 and 3.4).

[2] Article 3.2 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (OJ EU C113/1, 18.4.2012; Official Gazette RS, No. 35/2012, 14.5.2012).
[3] In last year's calculations the methodology for the calculation of the output function was changed (see EI 2013); this year there was a change in the calculation of the NAWRU (non-accelerating wage rate of unemployment, i.e. the natural unemployment rate). This was estimated in the EI 2013 with the traditional Philips Curve, which was replaced in this year's calculations by the New Keynesian Philips Curve. NAWRU is estimated this year using the real unit labour costs growth series in a bivariate unobserved component model. This is to make sure that the NAWRU as well as potential GDP growth calculations are less cyclical.

Chapter 2.2). Overall expenditure rose, driven by higher interest expenditure due to the surge in debt levels and expenditure on pensions as retirement accelerated prior to the entry into force of the pension reform. After having contracted in 2011 and 2012, investments also ticked up last year, which was associated to a large degree with increased inflows of EU funds. The increase in interest and social protection (pensions) expenditure, which accounted for the bulk of the overall expenditure increase in 2008–2013 (excluding expenditure on the recapitalisation of state-owned banks and companies), has thus been increasingly limiting the scope of fiscal policy action, as there is little wiggle room to raise taxes given Slovenia's standings in international comparisons of taxation levels.

Figure 7: **Changes in individual general government expenditure categories, 2008–2013, Slovenia**



Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, April 2014.

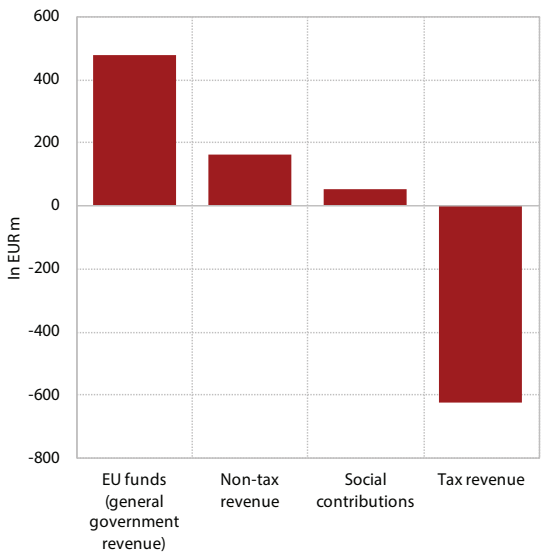
Despite a shift towards more permanent changes in the last two years, emergency measures still constitute the bulk of the fiscal effort. This applies in particular to general government expenditure. The measures adopted in 2012 introduced changes that have permanently curbed the growth of certain expenditure[16], in particular social transfers, although

[16] E.g. a change in eligibility criteria for social benefits, cuts in unemployment benefits, a reduction in the share of health care services covered by compulsory health insurance.

some measures affecting social transfers are still temporary[17] and mostly expire by the end of 2015. Likewise, in the field of public sector labour costs, only a handful of measures are permanent[18] and even these have a modest financial effect compared to the temporary measures that are to expire at the end of 2014. On the revenue side, however, the measures put in place are largely permanent.

The initial decline and subsequent subdued growth of economic activity, coupled with structural changes in the economy, have had a strong impact on changes in general government revenue since the start of the crisis. In the period before the economic crisis economic growth was underpinned by the growth of domestic and external demand. Since the start of the crisis, on the other hand, growth has been driven by external demand and the gap between domestic demand and gross domestic product has been widening. The 20% drop in domestic demand between its peak in 2008 and 2013 has translated into a contraction of tax revenue. To a certain extent, this is also a consequence of pre-crisis tax reforms that were not fiscally neutral, which were followed in 2012 by corporate income tax cuts (and the expansion of tax credits). The resulting revenue shortfall was only partially offset by increases in existing taxes (in particular, excise and VAT) and new taxes. The tax revenue of the general government thus remains below the 2008 level (by EUR 626m or 1.8% of GDP). Overall general government revenue exceeded the 2008 level for the first time in 2013, but this was a consequence of higher non-tax revenue, receipts of EU funds and, to a lesser extent, social contributions, which however dropped in the last two years.

Figure 8: **The change in general government revenue, 2008–2013**

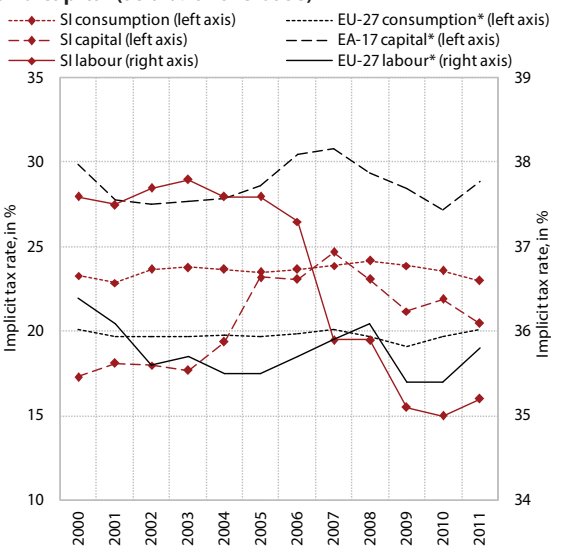


Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, April 2014.

[17] Freezing of the indexation of social transfers, reduction of the annual allowance for pensioners.
[18] Discontinuation of an allowance for women with over 25 years of service, halving of allowances for having a specialisation, masters degree or doctoral degree, a reduction in the allowance for work absence due to illness or injury outside the workplace (to 80% from 90%).

The tax changes instituted in recent years have shifted taxation from labour and capital to consumption. In the period of peak growth (2005–2008) the share of tax revenue did not rise like it did in other EU countries, rather it declined. Tax reforms during this period were not fiscally neutral in the sense of expanding the tax bases or introducing alternative tax sources (neither were they coupled with permanent spending cuts). Revenue dropped sharply with the onset of the crisis and the majority of tax changes taken since then – with the exception of the corporate income tax – have been targeted towards raising more tax revenue. Tax changes in the period 2005–2013 therefore shifted the tax burden from labour and capital to consumption. The implicit tax rate on labour was lower in 2012 than in 2005, placing Slovenia in the middle of EU rankings (eleven countries had higher rates). Nevertheless, international comparisons show that the position of Slovenia with regard to labour taxation depends on the level of wages. The tax wedge calculated for different types of families by the OECD for 2013 shows a relatively favourable taxation of Slovenian wages for individuals or couples with two children and wages below the national average. However, high marginal

Figure 9: **The implicit tax rate on consumption, labour and capital (as a % of the base)**



Source: Eurostat: Taxation trends in the European Union 2013, Government finance statistics, Implicit tax rates by economic function 2013.
Note: Data for the EU and the EA are weighted averages.

Box 2: **General government revenue from EU funds**

In the programming period 2007–2013 EU grants were absorbed successfully (with the exception of Cohesion Fund grants), being primarily allocated to financing investments and subsidies. In this programming period Slovenia was eligible for EUR 4.2 bn in cohesion policy funds, of which EUR 4.1 bn for three operational programmes (OPs). By the end of 2013 (data from the Ministry of Economic Development and Technology) all the available grants were appropriated along with additional drawing rights. In the entire period contracts worth EUR 3.8 bn were signed (92.5% of eligible funds), beneficiaries were disbursed EUR 2.5 bn (62.4% of eligible funds) from the national budget, and EUR 2.4 bn (59.4% of eligible funds, 95.1% of allocated funds) was refunded to the state budget. By the end of 2013 there were far fewer delays (totalling EUR 124.9 m) than in previous years[1], a consequence of simplified refund procedures and better cooperation between ministries. In the period from 2007 to 2013 the best success rate was recorded for the absorption of funds for the operational programme for the strengthening of regional development potentials, while the worst realisation was recorded for Cohesion Fund grants earmarked for the financing of environmental and transport infrastructure projects. The absorption of Cohesion Fund grants otherwise improved in 2013, whereas the absorption of grants from Structural Funds (ERDF and ESF) was level compared to 2012.

Slovenia still has institutional problems with regard to the absorption of EU funds, whereas sources of co-financing are limited due to the economic crisis. In order to avoid losing grants (the n+2/3 rule)[2], Slovenia adopted certain measures, including approving additional drawing rights for all OPs for back-up projects with a low risk of implementation. The bulk of the additional drawing rights were approved for environmental and transport infrastructure projects (EUR 307.3 m). In order to avoid losing funds, the funding was reallocated between OPs (this option expires at the end of 2015), while major projects were divided into phases, some of them pushed forward into the programming period 2014–2020. Like other EU Member States, Slovenia has been facing problems in absorption due to limited co-funding sources for the beneficiaries and the state. There have also been problems with environmental permits, project and investment documentation, frequent complaints, and long audit procedures. Citing alleged irregularities in the absorption of funds, the European Commission in March 2014 temporarily suspended Cohesion Policy grants (OP SRDP and OP ETID). The detected irregularities are said to refer to the execution of individual public contracts. Slovenia also has institutional problems in drawing EU funds. At the beginning of 2014 the Government Office for Development and Cohesion Policy was established to improve the efficiency of absorption. According to European Commission data, Slovenia places 10th among the Member States in terms of the absorption rate (50.58%, EU average 48.04%) and 5th among the new Member States (Croatia excluded; DG Budget, Absorption Rate of Structural and Cohesion Funds, 2007–2013, as at 31 December 2013).

Table 5: **Absorption of EU funds in 2007–2013 by operational programme, in EUR m, as at 31 December 2013**

Operational programme	Eligibility 2007–2013	Appropri-ations	Signed contracts	Disburse-ments	Refunds to the state budget	Delays	Absorption rate %
OP SRDP	1.783,3	2.232,9	1.719,7	1.397,9	1.335,9	62,0	74.9
OP HRD	755,7	803,6	726,9	545,9	502,7	43,2	66.5
OP ETID	1.562,0	1.831,3	1.348,1	617,8	598,2	19,6	38.3
Cohesion Policy total	**4.101,0**	**4.867,8**	**3.794,7**	**2.561,6**	**2.436,8**	**124,8**	**59.4**

Source: Ministry of Economic Development and Technology.

Note: * OP SRDP – Operational programme for strengthening regional development potentials, OP HRD – Operational programme for human resources development, OP ETID – Operational programme of environmental and transport infrastructure development.

Table 6: **Annual absorption of funds by policy, 2007–2013, in EUR m, as at 31 December 2013**

Fund/policy	2007	2008	2009	2010	2011	2012	2013
European Regional Development Fund	0.0	0.0	78.8	308.2	382.3	326.0	277.5
European Social Fund	0.0	0.0	6.4	104.7	134.3	107.4	155.5
Cohesion Fund	0.0	0.0	104.9	99.4	60.2	107.0	193.3
Agriculture and fisheries policy	0.1	208.3	220.3	217.9	220.2	267.5	271.7
Other	0.0	15.8	35.9	20.3	15.1	33.7	35.7
Total	**0.0**	**224.1**	**446.3**	**750.5**	**812.1**	**841.6**	**933.7**

Source: Ministry of Finance.

[1] By the end of 2012 there were delays totalling EUR 249.7 m.
[2] Funds allocated in a certain year must be used in the next two or three years.

tax rates on wages that exceed the national average[19] remain problematic in terms of incentivising employees (highly educated workers in particular). At equal net nominal wages that exceed the Slovenian national average (EUR 25,000/50,000/75,000 at the annual level), employers in Slovenia had higher labour costs in 2013 than employers in Austria or in any of the four Višegrad Group countries[20], a consequence mainly of the absence of a cap on social contributions. The implicit tax rate on capital, which had already been below the EU average in 2008, decreased even more sharply in 2005–2012 on the back of lower corporate income tax. However, the trend was the same in the EU as well, as the average implicit tax rate on capital dropped at the fastest pace. The implicit tax rate on consumption was at the 2005 level in 2012 according to the latest data, but we estimate that it rose in 2013 following the VAT rate increase although it was already among the highest in the EU-27 in 2011 (seven countries had higher rates).

2.2 Public finances in Slovenia in 2013

In 2013 consolidation came to a halt and the general government deficit reached a record level due to extraordinary recapitalisation expenditure. After the general government deficit contracted sharply in 2012 for the first time since the start of the economic crisis, reaching 4.0% of GDP (EUR 1,414 m), it rebounded to 14.7% of GDP (EUR 5,178 m) in 2013. The bulk of the deficit (EUR 3,633 bn) is associated with expenditure to shore up the capital adequacy of the banking system, but there were other one-off factors as well, including net expenditure on the delayed payment of wage disparities in the public sector (EUR 104 m) and the payment of compensation to persons erased from the register of permanent residents (EUR 126 m)[21]. Excluding the one-off factors in 2012 and 2013, the deficit contracted marginally (to 3.7% of GDP from 3.8% of GDP), as did the primary deficit (to 1.1% of GDP from 1.5% of GDP). The structural deficit contracted by 0.3 percentage points last year, a pace much slower than in 2012 (see Chapter 2.1).

The economic crisis and the structural deficiencies of Slovenia's public finances have resulted in rapid growth in interest expenditure, which was particularly pronounced last year. In 2013 compensation of employees saw the biggest drop among all expenditure categories (-3.7%). The decline was even sharper than in the year before, a result not only of the statutory changes enacted in 2012, but also of the adoption of an additional agreement to cut wages and labour costs[22]. Employment in the general government sector also dropped (-1.5%), the first time since the start of the crisis. The effect of measures to reduce the compensation of employees was almost equal to the increase in interest

Table 7: **General government expenditure, Slovenia**

In EUR m	2007	2008	2009	2010	2011	2012	2013
Intermediate consumption expenditure	1,939	2,245	2,301	2,418	2,511	2,451	2,363
Compensation of employees	3,641	4,112	4,399	4,500	4,616	4,492	4,324
Other taxes on production	114	71	9	9	9	11	9
Subsidies	541	582	682	704	390	352	352
Interest	438	416	479	583	697	760	917
Current taxes on income, property, etc.	15	14	4	4	8	3	3
Social benefits and assistance	5,624	6,189	6,629	6,877	7,158	6,992	7,006
Other current transfers	549	725	780	711	790	720	940
Capital transfers	282	368	283	233	562	137	3,705
Gross fixed capital formation	1,461	1,640	1,632	1,581	1,267	1,164	1,312
Other expenditure	22	46	37	-66	26	5	15
Total general government expenditure	14,625	16,410	17,235	17,553	18,034	17,086	20,945

Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, March 2014.

[19] OECD Taxing wages 2014, pp. 67 and 77.
[20] IMAD calculations, June 2014.
[21] The settlement of wages and the payment of compensation are liabilities incurred in 2013 based on court decisions and statutory regulations.
[22] Wages in the general government sector contracted by 2.5% last year. Additional measures agreed in 2013 included: a reduction in basic wages (partly linear, partly progressive, on average by about 1.3%), the abolition of the allowance for women with over 25 years of service, and the halving of the allowance for having a specialisation, masters degree or doctoral degree.

Table 8: **General government revenue, Slovenia**

In EUR m	2007	2008	2009	2010	2011	2012	2013
Market output and output for own final use and other non-market output	901	996	999	1,046	1,157	1,172	1,125
Taxes on production and imports	5,016	5,225	4,862	4,979	5,043	5,067	5,312
Property income	247	331	194	309	263	395	447
Current taxes on income, property, etc.	3,168	3,320	2,931	2,908	2,884	2,717	2,591
Social contributions	4,814	5,326	5,388	5,495	5,523	5,480	5,377
Other current transfers	344	485	563	715	841	797	788
Capital transfers	120	25	52	18	16	43	127
Total general government revenue	14,609	15,707	14,988	15,471	15,727	15,672	15,767

Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, March 2014.

expenditure. Intermediate consumption expenditure continued to decline after having contracted in 2012 for the first time since the start of the crisis. Other expenditure categories, which had dropped in 2012, stagnated or increased in 2013, partly due to one-off factors. Following the recapitalisation of several state-owned banks and companies in 2011, capital transfers dropped in 2012 before rising sharply in 2013 due to bank recapitalisation (in the amount of 10.3% of GDP). Gross fixed capital formation rose as well after having been contracting since the start of the economic crisis, in particular in 2011 and 2012. Social benefits in cash and kind, which declined for the first time since the start of the crisis in 2012, remained roughly level. The contraction in 2012 had been largely a result of stricter eligibility criteria. Some social benefits (parental benefits and certain other family benefits) continued to decline, largely due to the ongoing effect of the changes[23] enacted in 2012. On the other hand, pension expenditure, which accounts for over half of overall social benefits and had stagnated in 2012, rose significantly in 2013. This was the effect of a surge in the number of claimants of old age pensions prior to the implementation of the new pension act (see Chapter 5). Expenditure on subsidies remained level over 2012 following two years of decline. The inclusion of back pay (the third part of a wage increase undertaken to eliminate wage disparities in the public sector) and compensation of persons erased from the register of permanent residents in 2013 expenditure, based on court decisions and legislative commitments adopted by the government last year, resulted in a sharp increase in expenditure in the category *other current transfers*[24] (see Table 7).

General government revenue rose in 2013 on the back of measures to raise additional tax revenue and a record level of absorption of EU funds. Higher VAT rates and more efficient tax collection (the implementation of a programme for cracking down on the shadow economy) significantly increased tax receipts from this source in 2013. Revenue from a CO_2 tax that was enacted in 2012 and remained in place through 2013 rose sharply as well, with additional revenue secured by a new gaming tax. This led to a significant increase in taxes on production and imports, which had stagnated in 2012. Revenue from taxes on capital also rose modestly, a result of increased receipts from taxes introduced in 2012, although these account for a minor portion of overall tax revenue. Due to the continued weakening of the labour market and accelerated retirement prior to the implementation of the pension reform in 2012, the number of employees dropped further, which affected revenue from income tax[25] and, for the second year in a row, social contributions. Wages also dropped. Receipts from the EU budget were higher as the absorption of funds from the Cohesion Fund improved (see Box 2). Non-tax revenue dropped following a sharp rise in 2012.

[23] The Fiscal Balancing Act reduced parental and child benefits, set a ceiling for eligibility for receiving a one-off allowance upon the birth of a child and the allowance for a large family, whereas the parental allowance increased. The Act on Emergency Measures in the Field of Labour Market and Parental Care, which entered into force on 1 August 2013, lowered the ceiling for the parental benefit.

[24] In accordance with the methodology, this expenditure was budgeted in its entirety in 2013 but in late 2013 and early 2014 only part of the settlement of wage disparities was actually carried out.

[25] Another factor depressing tax revenue was the change in income tax brackets under the Fiscal Balancing Act of 2013. A fourth bracket with a tax rate of 50% on income above five average wages (a tax base over EUR 70,000) was introduced, while the boundary between the second and third bracket was raised to EUR 18,000 from EUR 15,000. The effect on the reduction in revenue was calculated to be EUR 37 m prior to the implementation of the changes.

3 Assessment of consolidation plans in the Stability Programme 2014

3.1 The excessive deficit procedure and surveillance in Slovenia in the framework of enhanced coordination of fiscal policies in the EU

In the framework of surveillance of the correction of the general government deficit in 2013, the European Commission assessed that Slovenia had taken appropriate action. In December 2009, the EU Council, acting on the recommendation of the European Commission, launched an excessive deficit procedure against Slovenia and set 2013 as the deadline for correcting the deficit. Due to significantly altered macroeconomic circumstances relative to 2009, which affected the pace of consolidation of public finances, the EU Council issued new recommendations[26] in June 2013 and extended the deadline for the correction of the excessive deficit to 2015. Accordingly, Slovenia had to present an Economic Partnership Programme[27] laying out the measures to meet the commitments. Concurrently, it also prepared a Draft Budgetary Plan for 2014 in accordance with the provisions of the enhanced mechanism for the surveillance of public finances in the euro area. On the basis of both documents submitted to the EC in October 2013, and its autumn forecast, the EC assessed in November 2013 that Slovenia had taken effective action in 2013 and that additional efforts to correct the excessive deficit were not needed in that year. Having taken into account the structurally adjusted balance[28], which factors in some of the changes in economic trends since the recommendation was made (June 2013), the EC assessed that Slovenia had undertaken a sufficient fiscal effort given that the adjusted structural deficit dropped by 0.6% of GDP. This opinion was also supported by an analysis of the effect of all implemented revenue-side discretionary measures and general government expenditure measures (temporary and permanent), which amounted to 1.1% of GDP and was in line with the Council recommendations of June 2013.

In March 2014 the EC warned Slovenia that there were risks to the achievement of a timely correction of the excessive deficit. Already in November 2013 the EC stated that the Draft Budgetary Plan for 2014 was compliant with the Stability and Growth Pact rules but did not leave any margin for possible slippage. In March of this year it assessed, based on its winter forecast (January 2014), which projects a deficit of 3.9% of GDP this year and 3.3% of GDP in 2015, that there were risks to the achievement of a durable correction of the deficit by 2015. In a special recommendation it urged Slovenia to ensure compliance with the Council recommendations of June 2013 and adopt the necessary measures to ensure that the required fiscal effort (reduction of the structural deficit) is achieved.[29]

In June 2014, based on the measures proposed in the SP2014, the EC assessed that Slovenia risked not achieving the recommended deficit objectives in 2014 and 2015. In its opinion regarding the proposed recommendations for the correction of the excessive deficit[30], which takes into account its spring forecast[31], the EC assessed in June 2014 that there were risks that the proposed measures would not provide a sufficient fiscal effort and the improvement of the structural balance would fall short of the forecasts in the programme. It issued a recommendation that Slovenia must enhance its budgetary strategy with sufficiently specific structural measures in order to correct the deficit in 2015. To improve the credibility of fiscal policy, it must prepare as soon as possible the legal basis for the implementation of the fiscal rule and the operation of the Fiscal Council. The EC further recommended a comprehensive review of health expenditure at all levels, and an agreement based on public consultations on measures to ensure the sustainability of the pension system and limit expenditure on long-term care. The EC opinion also highlights the fact that numerous measures underpinning the SP2014 projections have yet to be adopted.

[26] Council of the European Union: Council recommendation to Slovenia with a view to bringing an end to the situation of an excessive government deficit (18 June 2013).
[27] In accordance with Regulation (EU) No. 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.
[28] Structural deficit adjusted for: a) change in potential output relative to the initial projections at the time of the recommendation, b) the impact of a revision of economic growth or shortfall of the general government revenues, and c) other one-off events affecting the general government balance.
[29] European Commission: Commission recommendation of 5.3.2014 regarding measures to be taken by Slovenia in order to ensure a timely correction of its excessive deficit.
[30] European Commission: Commission staff working document: Assessment of the 2014 national reform programme and stability programme for Slovenia (2. 6. 2014).
[31] The EC spring forecast projects a deficit of 4.3% (including bank recapitalisation of 0.9% of GDP) for 2014 and 3.1% of GDP in 2015, which misses the targets recommended under the excessive deficit procedure (3.3% in 2014 and 2.5% in 2015). Likewise, the improvement of the structural deficit (calculated from the output gap) is projected by the EC to be slower than required (0.0 percentage points in 2014 and 0.2 percentage points in 2015, versus the target of 0.5% each year).

3.2 Summary of guidelines and objectives in the Stability Programme 2014

The primary objective of economic policy in the Stability Programme 2014 is to establish conditions for the promotion of economic growth and to enhance the prosperity of the population. The key priorities pursued in the achievement of these objectives are the stability of public finances – the aim being to achieve a structural balance by 2017 – and increasing the active working population to 850,000 persons.

In order to revive economic growth, the SP2014 prioritises action in three key areas set down in the National Reform Programme 2014:
1. The financial pillar (restructuring of the banking system, deleveraging and restructuring of companies, insolvency);
2. Corporate governance and privatisation (Slovenia Sovereign Holding, privatisation);
3. The fiscal pillar (the fiscal rule, medium-term fiscal planning, long-term debt sustainability, consolidation).

The fiscal pillar of the SP2014 focuses on framing policies targeted at reducing the deficit and stabilising public debt. The SP2014 states that Slovenia's fiscal policy objectives for 2014 and 2015 are compliant with the demands and recommendations of the EU Council in the framework of Stability and Growth Pact commitments, and in line with the requirements under the excessive deficit procedure. These require that the deficit be brought below 3% of GDP by 2015. For other areas of the fiscal pillar that are designated as priorities in the SP2014 (the law implementing the fiscal rule, medium-term budgetary planning), the document does not state any planned activities, nor does it set a time frame for the implementation of changes in this field.

3.3 The macroeconomic framework of fiscal consolidation

The macroeconomic scenario of the Stability Programme 2014 assumes a continuation of the gradual recovery of economic activity. Last year's contraction of gross domestic product (-1.1%) was already slower than it had been in 2012, mostly due to growth in the final quarter. Exports grew robustly and the contraction of domestic consumption expenditure slowed down. The Spring Forecast 2014 (IMAD), which constitutes the macroeconomic framework of the fiscal consolidation in the SP2014, assumes that the recovery will continue this year and beyond. Growth will remain weak and it will still be underpinned by exports growth, but for the first time since the start of the crisis domestic consumption expenditure is expected to have a positive contribution to growth in 2015, which represents a positive turnaround in terms of revenue. The forecast upgraded this year's growth projection and downgraded the projections for the subsequent years compared to the Spring Forecast 2013, which represented the basis for last year's Stability Programme.

Last year the first steps were made towards the restructuring of the banking system. After bank stress tests and recapitalisation were carried out at the end of last year, Slovenia's standing on international financial markets strongly improved, facilitating access to foreign financing. The yields on government bonds dropped sharply and at the start of this year Slovenia returned to the Eurobond market for the first time since 2011. The transfer of non-performing claims to the Bank Assets Management Company and the restructuring of highly indebted companies (see the Section entitled Corporate Indebtedness and Deleveraging) continue as well. Deleveraging of the corporate sector following the initiation of bank stabilisation represents the main challenge to the successful continuation of corporate restructuring

Table 9: **Macroeconomic assumptions in the consolidation of public finances in the SP2013 and SP2014**

	2013	2014	2015	2016	2017	2018
GDP in EUR m (SP2013)	35,252	35,735	36,810	38,110		
GDP in EUR m (SP2014)	35,275	35,634	36,255	37,219	38,414	39,662
Nominal GDP growth, in % (SP2013)	-0.6	1.4	3.0	3.5		
Nominal GDP growth, in % (SP2014)	-0.1	1.0	1.7	2.7	3.2	3.2
Real GDP growth, in % (SP2013)	-1.9	0.2	1.2	1.6		
Real GDP growth, in % (SP2014)	-1.1	0.5	0.7	1.3	1.7	1.7

Source: SURS; Spring Forecast of Economic Trends 2013, IMAD, Spring Forecast of Economic Trends 2014, IMAD.

and, consequently, the damming of the spillover of risk between the private and the public sector. Efficient implementation of these processes will also encourage economic recovery and facilitate the achievement of the fiscal consolidation objectives.

3.4 Assessment of the 2014 update to the Stability Programme

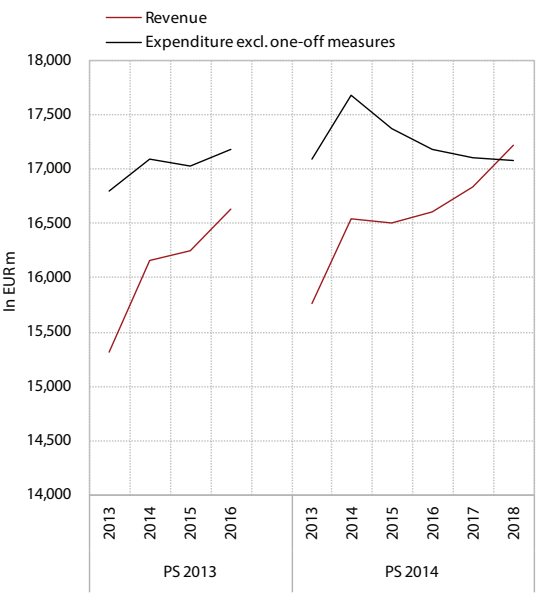
Under the SP2014, the deficit will be reduced in line with the EU Council recommendation on the correction of the excessive deficit. The SP2014 pursues the objective of Slovenia reducing the general government deficit to 3.2% of GDP this year and 2.4% of GDP in 2015, one-off expenditure excluded. Bank recapitalisation is planned to amount to 0.9% of GDP, which will increase the deficit to 4.1% of GDP this year. The structural deficit is projected to drop as well, by 0.6 percentage points in 2014 and 0.5 percentage points in 2015.

The mix of deficit-cutting policies in the SP2014 focuses on three areas. The consolidation is underpinned by revenue growth while expenditure is projected to rise in 2014 before declining in 2015, bringing expenditure to the 2013 level by the end of the programming period. On the expenditure side, the strategy partly relies on reducing debt in 2016–2017 with proceeds from privatisation, which will significantly contribute to the planned stabilisation of interest expenditure towards the end of the programming period.

The strategy differs from that in the SP2013, which assumed even higher revenue growth and did not involve expenditure cuts except in 2015. The deficit reduction planned in the SP2013 relied to an even greater extent on revenue-side measures, in particular taxes, stemming from the planned introduction of a real estate tax, a crisis tax, and higher VAT rates. These measures are not planned in the SP2014 (except the VAT rate hikes), which reduces the projected contribution of taxes to consolidation on the revenue side. On the expenditure side, the SP2013 projected only a modest decline in primary expenditure in 2015 and growth in all other years. Such projections were possible due to the assumption that revenue growth would be higher and the debt and interest dynamics would be substantially lower in the SP2013. But since debt surged in 2013, pushing up interest expenditure in 2014, the consolidation strategy under the SP2014 now assumes a decrease in primary expenditure after 2014, to the extent that the surge in interest in 2014 is entirely absorbed through 2018.

Aside from the change in the combination of deficit-cutting measures, this year's Stability Programme assumes a slower pace of consolidation, in particular in 2014. Compared to the SP2013, the SP2014 projects higher revenue and expenditure, but the difference in expenditure is slightly bigger, which slows the consolidation compared to the SP2013. The deviation is biggest in 2014, to a significant extent due to one-off measures precipitated by changes in the bank recapitalisation process compared to last year's plans. However, even the increase in expenditure excluding one-off factors outpaces the projected revenue growth (see Figure 10). Under the SP2014, the deficit (excluding bank recapitalisation) is projected to be brought below the 3% limit a year later (2015) than under the SP2013 (see Table 10). The deferral was made possible by the Council decision of June 2013 that the deadline for the correction of the deficit be shifted to 2015 from 2013. The higher revenue projections in the SP2014 are based on assumptions of higher non-tax revenue, whereas tax sources were significantly downgraded compared to earlier projections. Higher expenditure projections (excluding one-off events) hinge on higher interest expenditure and investments, which is partly associated with the projections for EU funds.

Figure 10: **Projections of revenue and expenditure (excluding one-off factors) of the general government in SP2013 and SP2014**



Source: Stability Programme (Update 2013), Stability Programme (Update 2014).

Box 3: **Methodological changes in the accounting of general government revenue and expenditure related to EU funds that affect the comparability of the SP2013 and SP2014**

In accordance with the methodology applicable when the Stability Programme 2013 was adopted, general government revenue and expenditure included all EU funds, regardless of whether the recipients (revenue) or beneficiaries (expenditure) were a part of the general government sector. In the autumn of 2013 the statistical publication of data on the main aggregates of the general government for 2012 revised the general government revenue and expenditure for 2004–2011 and excluded EU funds whose recipients or beneficiaries are legal entities outside the general government sector. General government expenditure/revenue as a share of GDP dropped after the review, but the effect of the methodological change on the deficit was neutral.

In order to ensure the comparability of the data, we excluded funds whose recipients or beneficiaries are outside the general government sector, even at its lower level, from revenue and expenditure projections in the SP2013. On the revenue side, these funds were excluded from the category *other revenue*, ensuring full compatibility of the data with the SP2014. On the expenditure side, the EU funds (all EU funds, including funds whose beneficiaries are outside the general government sector) in the SP2013 had been envisaged in a smaller number of categories than this year. As a result, the 2013 and 2014 projections of subsidies and, to a lesser extent, various current transfers (*other expenditure*) are not entirely comparable. Nevertheless, the differences stemming from the change of methodology do not significantly affect the key findings stemming from the comparison of these items.

In the rest of this chapter all data and comparisons of general government revenue and expenditure in the text, tables, and charts that refer to SP2013 data exclude EU funds whose recipients/beneficiaries are outside the general government sector.

Table 10: **Comparison of revenue, expenditure, and deficit in the SP2013 and SP2014, as a % of GDP**

	SP 2013				SP 2014					
	2013	2014	2015	2016	2013	2014	2015	2016	2017	2018
Revenue	43.4	45.2	44.1	43.6	44.7	46.4	45.5	44.6	43.8	43.4
Expenditure	51.4	47.8	46.3	45.1	59.4	50.5	47.9	46.1	44.5	43.1
Net lending/borrowing	-7.9	-2.6	-2.1	-1.4	-14.7	-4.1	-2.4	-1.5	-0.7	0.3
One-off expenditure/bank recapitalisation	3.7				10.3	0.9				
Net lending/borrowing excluding recapitalisation expenditure	-4.2	-2.6	-2.1	-1.4	-4.4	-3.2	-2.4	-1.5	-0.7	0.3

Source: Stability Programme (Update 2013), Stability Programme (Update 2014).

The revenue growth planned in the SP2014 is based on faster growth of tax revenue compared to other general government revenue. Tax revenue is projected to grow by 5.8% in 2014 before it declines in 2015 and rebounds in 2016 at a pace slower than nominal GDP growth. The sharp tax revenue growth in 2014 is underpinned by increased revenue across all tax categories (taxes on production and imports, taxes on income and property, and taxes on capital; see Table 11). The improvement only partly reflects the projected uptick in economic activity and is largely a result of discretionary measures adopted last year (e.g. the whole-year effect of last year's increase in VAT rates, further measures to curb the grey economy). Additionally, the SP2014 projects further measures to realise the planned tax revenue which had not been planned in the SP2013. For the current year, the SP2014 thus projects a) an increase in excise duties on certain energy products, alcohol and tobacco and the discontinuation of refunds of a part of excise duty on biofuels[32]. For the period starting in 2015, the SP2014 projects b) an improvement in the efficiency of debt recovery in conjunction with corporate restructuring, c) higher rates of the financial services tax in 2015, when the tax on bank balance sheets expires, d) higher tax rates on insurance transactions, and e) the extension of the fourth income tax bracket (for income exceeding five average wages), which had been introduced as a stop-gap measure for 2013 and 2014 (Fiscal Balance Act). Another significant source of tax revenue in 2014 is the sale of wireless spectrum licenses, which has already been completed.

[32] These increases were implemented as part of measures that the government adopted in April 2014 to offset the shortfall of revenue from the real estate tax in the adopted budget for 2014 (Information on measures to balance the national budget in 2014).

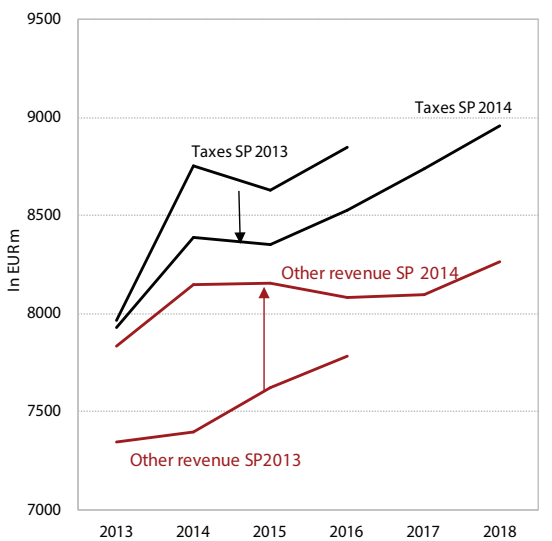
Table 11: **Projections of general government revenue in the SP2014**

	Nominal revenue growth in the SP2014, in %				
	2014	2015	2016	2017	2018
Total general government revenue	4.9	-0.2	0.7	1.3	2.3
Taxes on production and imports	6.9	-0.8	2.1	2.2	2.3
Current taxes on income, property	3.2	1.2	2.3	2.8	2.9
Taxes on capital	45.2	-73.5	-16.3	1.6	1.7
Social contributions	1.3	1.2	2.3	2.8	2.9
Property revenue	-12.5	-28.3	-14.1	0.1	0.1
Other revenue	14.6	2.2	-6.7	-6.4	0.0
of which EU funds	39.7	-3.7	-19.0	-34.6	-12.4

Source: Stability Programme (Update 2014).

These tax revenue projections are significantly lower than in the SP2013 despite the planned new discretionary measures. The lower level of tax revenue throughout the entire programming period compared to the SP2013 is strongly affected by the shortfall of real estate tax receipts after the Constitutional Court repealed the legal basis for such, the shortfall of receipts from the crisis tax[33], and partly by slower economic recovery (see Chapter 3.3). The SP2013 assumptions also included the introduction of a tax on sweet beverages, which was not adopted. Even if it had been, it would not have constituted a significant new revenue source. For the entire programming period 2014–2016 only projections of receipts from taxes on production and imports (VAT, excise duties and, in 2014, the one-off revenue from the sale of wireless spectrum licenses) are higher than last year's.

Figure 11: **Projections of tax and other general government revenue in the SP2013 and SP2014**



Source: Stability Programme (Update 2013), Stability Programme (Update 2014).
Note: Other revenue: social contributions, revenue from property, other revenue (EU funds and other various transfers and capital revenue).

Under the SP2014 projection, non-tax revenue is significantly higher throughout the programming period than in the SP2013, but since the projected revenue is not entirely based on systemic fiscal sources, the receipts may be less reliable. SP2014 projections of non-tax revenue (social contributions, property income, EU funds and other miscellaneous non-tax revenue) are higher than in SP2013 due to higher realisation of revenue in 2013, which exceeded the plans in the SP2013, and higher growth planned in 2014 (4% compared to 0.7% in the SP2013). EU funds in particular stand out, as their level is planned to exceed 2013 projections by 40%, as do extraordinary non-tax revenue, duties and fines. Higher rates and the expansion of contribution bases for some categories of health insurance contributions, which was adopted last year, has led to higher projections of social contributions compared to the SP2013. However, beyond 2014 the growth in social contributions is projected to be more subdued than in the SP2013 due to a slower economic recovery. For 2014 the SP2014 also assumes higher revenue than the SP2013 from dividend receipts from state-owned companies and financial institutions.

The revenue projections in the SP2014 are subject to numerous downside risks. Consolidation in 2014 is based on increases in various types of non-tax revenue (extraordinary non-tax revenue, duties and fines) that are uncertain to be carried through as planned in the subsequent years considering the absence of implementing measures in the SP2014. There are also risks associated with the realisation of inflows of EU funds. The temporary suspension of the reimbursement of cohesion policy funds by the EC in March 2014[34] already slowed down the

[33] The SP2013 allowed for the possibility of the introduction of a crisis tax as at the start of 2014 as a conditional measure in the event that consensus on additional permanent expenditure-side measures was not achieved, but it never came to pass.
[34] The EC temporarily suspended the payment of cohesion policy funds due to irregularities in the use of funds in the operational programmes Regional Development and Development of Environmental and Transport Infrastructure. The suspension can last a maximum of 6 months.

absorption of EU funds this year. In the event that the suspected shortcomings are confirmed by the EC, the shortfall of funds will not be revenue-neutral: under the system of advances from the national budget, the payments from the budget will as a rule be carried out as planned, but the EC will not reimburse the funds[35]. Lower realisation of EU funds could also affect economic activity. Another, more moderate, risk stems from the planned realisation of certain taxes (corporate income tax, partly VAT), where the projected receipts in individual years exceeds the projected growth of the tax bases. Tax revenue overall could remain below target in the event of a more sluggish pace of economic recovery in the programming period. Such risks have been realised in recent years and the SP2014 is based on worsened medium-term macroeconomic frameworks with regard to the SP2013. Furthermore, a portion of the planned measures to raise more revenue also requires legislative changes that could be delayed due to the early general election. Finally, with the real estate and crisis taxes having been abandoned (notwithstanding the appropriateness of these measures), the SP2014, unlike the SP2013, assumes one-off non-tax revenue (the sale of concessions, corporate profits, certain extraordinary non-tax revenue), which does not constitute a systemic fiscal source that would address the long-term fiscal challenges; the proceeds from these sources are also less reliable than tax sources. In this respect, the stated goal in the SP2014 that the real estate tax be adopted again after the contested provisions of the legislation are improved, appears to be an appropriate measure. This would also have a positive impact on spatial planning policy and the real estate market.

The consolidation measures in the SP2014 indicate four principal fiscal policy objectives:

- Expenditure excluding one-off events is projected to remain level over the medium term: after an uptick in 2014, it is projected to contract through the end of the programming period, achieving the 2013 level by 2018.
- In the short term, economic activity will be stimulated with the expansion of public investments (partly in conjunction with EU funds), as was the case in 2013.
- Throughout the entire period the only primary expenditure projected to increase are social benefits and transfers, which is entirely attributed to higher pension and health expenditure.
- The decline in expenditure beyond 2016 hinges on debt reduction with proceeds from privatisation, which makes it possible to reduce interest expenditure in this period (see Table 12).

The significant increase in interest expenditure will weigh heavily on fiscal consolidation through the end of the programming period. The 3.4% expenditure growth projected for 2014, excluding one-off events, is a consequence of a surge in expenditure on interest (34%) and investments (25.1%) and, to a lesser extent, social benefits and other expenditure (0.7%), whereas other expenditure categories are already projected to contract (see Table 12). From 2015 through the end of the programming period only social transfers and benefits are projected to grow, all other expenditure categories are contracting. The spike in debt incurred during the crisis is projected to push interest expenditure to EUR 1.2 bn in 2014, a level that is

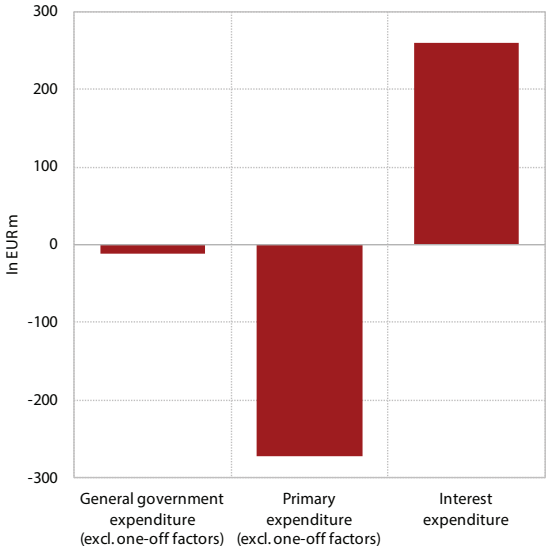
Table 12: **Projections of growth in general government expenditure in the SP2014**

	Nominal expenditure growth in SP2014, in %				
	2014	2015	2016	2017	2018
Total general government expenditure	-14.1	-3.5	-1.2	-0.4	-0.1
Expenditure excl. one-off factors*	3.4	-1.7	-1.2	-0.4	-0.1
Expenditure excl. one-off factors* and interest	1.7	-1.6	-1.4	-0.2	-0.1
Compensation of employees	-0.8	-2.3	-1.0	-0.7	-0.6
Intermediate consumption	-2.1	1.9	-6.1	-1.3	0.9
Total social benefits	0.7	0.8	0.9	0.9	0.9
Interest expenditure	34.1	-2.9	2.3	-3.3	-0.3
Subsidies	-10.2	-29.2	-4.0	-1.4	-1.1
Gross fixed capital formation	25.8	-4.6	-6.8	-6.8	-5.9
Other expenditure**	-75.5	-36.7	0.8	9.4	1.1
Other expenditure** excl. one-off factors	0.7	-12.1	0.8	9.4	1.1

Source: Stability Programme (Update 2014).
Note: * The figures for 2013 and 2014 include bank recapitalisation, the figure for 2013 additionally includes the settlement of wage disparities in the public sector and compensation for those persons erased from the register of permanent residents based on court decisions. ** Other expenditure includes: Other taxes on production (expenditure), current taxes on income, property (expenditure), other current transfers, capital transfers.

[35] The suspension affects EUR 185 m that Slovenia requested in December 2013 and EUR 75.6 m that it requested in May 2014. The funds have already been transferred to beneficiaries due to the system of advance payments from the national budget.

Figure 12: **The crowding out of primary expenditure by interest in 2013–2018 (the difference between expenditure anticipated in 2018 and expenditure in 2013)**



Source: Stability Programme (Update 2014).

expected to persist throughout the programming period. The projected increase in interest is already high under the SP2014 assumptions, but in the event of delays in privatisation, which forms part of the debt reduction strategy in 2016 and 2017 (see Chapter 4), such expenditure will swell even more sharply. Potential one-off events also constitute a risk of increased indebtedness. The projected increase in social transfers and benefits through the entire programming period is based on the planned rise in health and pension expenditure. It is difficult to assess to what extent these projections reflect potential systemic changes that are not explicitly stated[36] in the SP2014 but are nevertheless likely to occur before the end of the programming period. A change in pension legislation would probably lead to a surge in early retirement (just as it did in 2010 and 2012) due to uncertainty about its effects. This could raise the level of pension expenditure to above the levels planned in the SP2014 until the end of the programming period. Projections of social transfers and benefits are partly based on the assumption that social policy measures (related to transfers) will be extended until the objective of increasing the size of the active working population to 850,000 is achieved, but this has yet to be signed into law [37].

[36] The SP2014 states that changes in health insurance rights, the shift from hospital to outpatient treatment, the strengthening of primary health care, the streamlining of the financing scheme, the expansion of the contributions base to working students, the adjustment of insurance for pensioners, and the financing of long-term care are being examined based on a variety of studies. It also says that the key measures going forward will be to streamline and optimise the network of providers of public health care.

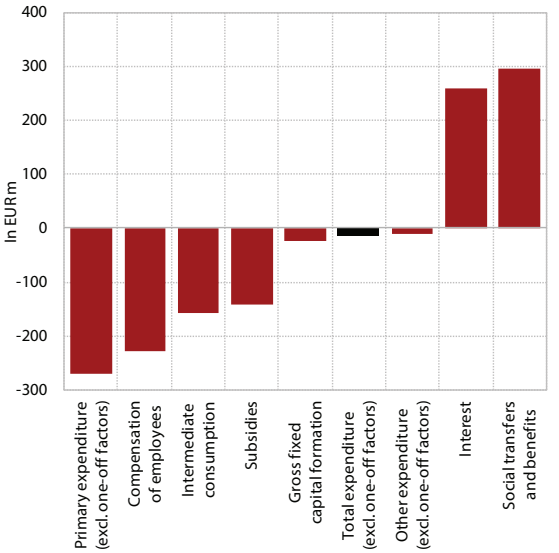
The expenditure-side consolidation laid out in the SP2014 is driven by an insufficiently defined reduction in compensation of employees, intermediate consumption and subsidies, which we believe represents a considerable downside risk to the projections. Throughout the entire period these categories of expenditure are mostly projected to drop. The SP2014 assumes that the validity of wage measures adopted in 2013 and 2014[38] to curb labour costs in the general government sector will be extended until the goal of 850,000 people in the active working population is achieved. Cutting labour costs is a sensible consolidation measure, but Slovenia's approach, largely unchanged in recent years, is based on a linear or progressive reduction in wages and other allowances, which does not provide a stimulating environment for employees. Considering that the prolongation of existing measures can only stabilise the expenditure level whereas the SP2014 assumes that compensation of employees will contract every year through 2018, the assumption is that the number of employees will be reduced and additional measures will be taken to realise this objective, although they are not specified in the SP2014. Since the start of the crisis, the only time that the number of employees in general government dropped was last year. The trends for this year already indicate a loosening of the commitment to reduce the headcount linearly by 1% per year, which is a result of the absence of implementing measures. The SP2014 also does not provide possible solutions to cut the number of employees. Achieving consensus with social partners – talks are ongoing – represents an additional risk to the achievement of objectives regarding the reduction of labour costs. Besides labour costs reduction, the projected scaling back of subsidies is a significant consolidation factor as well, in particular in 2014 and 2015. To achieve that, a change in the system of subsidies is planned for 2014 in order to increase the share of refundable funds and hence the share of financial mechanisms (loans, guarantees, capital stakes, venture capital). The relevant legal basis for these changes has yet to be adopted. Expenditure cuts will also be achieved with the contraction of general government intermediate consumption. Reduction of this expenditure has heretofore been based on a linear approach that does not take into account the differences between institutions. It is our belief that further cost cuts will

[37] In accordance with the Budget Implementation Act for 2014 and 2015, pensions and social transfers (except minimum income) will not be indexed until 31 December 2015.

[38] Under the Fiscal Balancing Act and the Budget Implementation Act for 2013 and 2014. As of January 2015, the following measures will expire: wage cuts, the reduction of supplementary pension insurance premiums for civil servants, the freeze on promotions and regular performance bonuses. Certain elements have not been agreed yet (regular annual leave, wage rises).

require a departure from this approach. The reduction dynamics in the SP2014 – contraction of intermediate consumption expenditure in 2014, growth in 2015 and sharp contraction in 2016 – indicate that the streamlining of government spending is not underpinned by measures with lasting effect. Instead, this expenditure is largely adjusted to the planned dynamics of other expenditure in order to achieve the target deficit in the given year.

Figure 13: **Changes in individual expenditure categories in the SP2014, 2013–2018**



Source: Stability Programme (Update 2014).

There are also risks associated with low projections of certain social transfers and miscellaneous current transfers. For 2014–2018, transfers to individuals and households (transfers to the unemployed, family benefits, etc.) are projected to be below their 2012 level. The SP2014 says that these estimates are based on current trends, forecasts for the economic cycle and adopted regulations, and it assumes a more expansive implementation of the active employment policy. Deviations from the projected trajectory of economic recovery and problems in securing additional funding for the active employment policy could jeopardise the realisation of these objectives. In 2015 consolidation on the expenditure side also assumes a relatively strong (-12%) decrease in the category *other expenditure* (in particular, miscellaneous current transfers), which is, however, not supported by planned measures. To a certain extent, the decrease in these transfers is associated with lower budget transfers to public institutions due to plans to use up the surpluses they have accumulated over the years, but the National Assembly has already rejected the provision (a part of the amended Budget Implementation Act for 2014 and 2015) that would make this possible.

Slovenia can achieve its objectives with the consolidation strategy in the SP2014, but this requires the timely adoption of measures planned in the SP2014 as well as additional measures. Fiscal policy remains committed to the objective of reducing the deficit below 3% of GDP in 2015. However, achievement of the objective may be hampered by the existing haphazard approach to consolidation which is not based on the timely adoption of measures with a permanent effect. In the short term, the main challenge will therefore be to adopt measures that will ensure the implementation of the consolidation plan in 2014 and 2015. The planned level of investments in individual years is in danger of falling short of targets owing to the failure to specify certain expenditure- and revenue-side measures. In 2014, for example, investments are projected to expand at a faster pace than inflows of EU funds, which means that investment projections have created some leeway for the reduction of this type of expenditure in the event of problems in meeting the objectives for other types of expenditure and revenue and hence the target deficit. This would, however, have an adverse impact on the role that government investments could have in stimulating economic growth.

Projections of the structural deficit, which are based on the assessment of the output gap, assume a fiscal effort that is in compliance with EU recommendations. The SP2014 assumes an equal fiscal effort for the entire programming period (see Table 13). In 2014 and 2015 it is projected at 0.6 and 0.5 percentage points, respectively, which is in line

Table 13: **Comparison of output gap-based projections of the structural deficit in the SP2013 and SP2014**

	2014	2015	2016	2017	2018
	SP 2013				
Structural deficit, as a % of GDP	-0.7	-0.8	-0.8	-0.4	
- change, in percentage points	1.2	-0.1	0.0	0.4	
	SP 2014				
Structural deficit, as a % of GDP	-2.0	-1.5	-1.0	-0.7	-0.1
- change, in percentage points	0.6	0.5	0.5	0.3	0.6

Source: Stability Programme (Update 2013), Stability Programme (Update 2014).

with the EC recommendation that the structural deficit be reduced by 0.5 percentage points annually over this period (see Chapter 3.1).

An additional estimate of the structural balance based on all adopted discretionary measures indicates a larger fiscal effort than the estimate based on output gap. This estimate is a bottom-up approach of the fiscal efforts of individual revenue- and expenditure-side measures. The Draft Budgetary Plan for 2014 (Ministry of Finance), which was submitted to the EC in October last year, shows that the adopted discretionary measures are projected to amount to 2.1% of GDP in 2014. Even though the measures are slightly different than in the SP2014, it is our assessment that they entail a bigger fiscal effort in 2014 than the change in the structural deficit calculated on the basis of the output gap. For example, certain revenue-side measures that have already been adopted (higher VAT, excise duties and health contribution rates) alone contribute around 0.6% of GDP. To ensure the required fiscal effort, it is therefore instrumental that all the planned measures be implemented. Compliance with the requirement regarding the nominal deficit will also depend on the actual pace of economic activity.

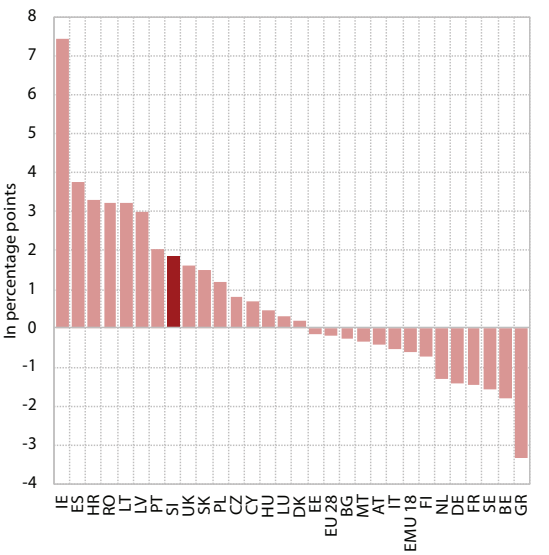
Slovenia has not succeeded in recent years in strengthening the institutional framework of fiscal policy. In May 2013 the National Assembly endorsed amendments to the Constitution introducing a balanced budget rule, which was to be followed within six months by an implementing act. The Act on Public Finances should have been changed as well to adjust the budgetary planning procedure and the adoption of supplementary budgets. These changes have yet to be carried out. The SP2014 blames the delay on the desire to achieve a broad consensus on the fiscal rule act and to present all possible scenarios of fiscal projections, which are very sensitive to macroeconomic forecasts. In order to preserve the credibility of the country, it is necessary to adopt the act in due time, but it is also important that the act take into account the current extraordinary economic circumstances. Considering that the implementing act on the fiscal rule has been delayed, the operation of the Fiscal Council, an independent institution assessing fiscal policy plans, has yet to be resolved as well. At present, the Fiscal Council, as defined in the Act on Public Finances, is inactive (its last report was issued in April 2012). Additionally, the role of other institutions which have been weakened in recent years (public administration) will have to be enhanced in the future. Only then can they act as competent interlocutors in the EU (in the framework of EU institutions), whose role in the planning and implementation of policies that are otherwise national competences has been increasing.

4 General government debt

4.1 General government debt in 2013

Last year's increase in the general government debt was the sharpest to date, and in the period since the start of the crisis Slovenia has gone from the group of countries with low debt to the group of countries with medium indebtedness. The increase in Slovenia's debt-to-GDP ratio in the past five years, amounting to 50 percentage points, was the sixth steepest among the EU Member States. Even though overall debt is not among the highest in the EU, the pace of the increase and the resulting rapid rise in interest expenditure, coupled with the required fiscal effort to reduce the general government deficit, is creating strong pressure on the structure of general government expenditure and increases the need for the adjustment thereof.

Figure 14: **Change in interest expenditure as a share of overall general government expenditure, 2008–2013**



Source: Eurostat.

The general government debt reached EUR 25.3 bn in 2013 or 71.7% of GDP, having increased by EUR 6.1 bn or 17.3 percentage points in a single year. The year-on-year increase in the debt-to-GDP ratio is entirely the result of the nominal debt increase, as nominal GDP remained level compared to 2012 (-0.1%). More than half of last year's debt increase is a consequence of bank recapitalisation (10.3% of GDP) and the issuance of a bond for the Bank Assets Management Company (BAMC). The debt was

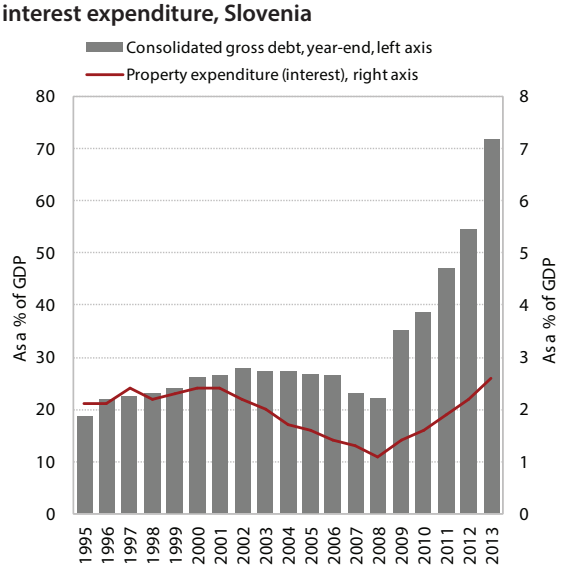
Table 14: **General government consolidated debt by sub-sector, Slovenia, 2008–2013**

	2008	2009	2010	2011	2012	2013
In EUR bn						
Total general government	**8.2**	**12.5**	**13.7**	**17.0**	**19.2**	**25.3**
Central government	8.1	12.1	13.2	16.4	18.6	24.8
Local government	0.4	0.5	0.6	0.7	0.7	0.7
Social security funds	0.0	0.0	0.1	0.1	0.1	0.0
Consolidated debt among sub-sectors	-0.3	-0.2	-0.1	-0.1	-0.2	-0.2
As a % of GDP						
Total general government	**22.1**	**35.2**	**38.7**	**47.1**	**54.4**	**71.7**
Central government	21.8	34.2	37.2	45.4	52.7	70.2
Local government	0.9	1.5	1.8	1.9	2.0	2.1
Social security funds	0.0	0.0	0.1	0.1	0.1	0.0
Consolidated debt among sub-sectors	-0.7	-0.5	-0.4	-0.4	-0.5	-0.5

Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, April 2014.

additionally pushed up by deficit financing. One-off transactions excluded, the deficit contributed 3.7% of GDP to the increase in the overall debt. To a lesser extent, the increase in 2013 was buoyed by the pre-financing of 2014 expenditure, including the restoration of cash reserves, which had been severely depleted at the end of 2012 (EUR 0.6 bn). The borrowing largely involved long-term instruments (5- and 15-year dollar bonds, a 3-year Eurobond and 18-month T-bills) and to a lesser extent short-term domestic borrowing with T-bills and loans.

Figure 15: **General government gross debt and interest expenditure, Slovenia**



Source: SI-Stat Data Portal – National accounts – General government accounts – Main aggregates of the general government, March 2014.

Debt of the central government, which is long-term (97.4%) and mostly euro-denominated, accounted for the bulk of overall debt (97% of general government debt at the end of 2013). In 2012 the share of short-term debt had risen (to 2.1% of GDP), but in 2013 it dropped slightly (to 1.8% of GDP). The debt is mostly euro-denominated, but the share of debt denominated in US dollars and converted into euros has widened. At the end of 2013, about 71.5% of the treasury debt was denominated in euros and 28.4% in US dollars. The borrowing dynamics at the local level slowed down in the past two years after having accelerated from 2008 to 2011 (by about EUR 100 m per year). The increase in 2013 (EUR 26.2 m) was similar as in 2012 (EUR 22.4 m), bringing total debt at the local level to 2.1% of GDP by the end of 2013. In the coming years, debt will mature at a fairly equal pace, with annual refinancing requirements averaging EUR 1.7 bn[39].

Borrowing conditions were tight in 2013, a situation that did not improve until the end of the year. In the first quarter of 2013 bond yields hovered around 5%, but in April the terms of borrowing deteriorated sharply on concerns about the most vulnerable euro area countries. The yield on Slovenian debt additionally rose due to doubts on international markets as to Slovenia's ability to finance the restructuring of its banking system. It hit 6.33%, the highest level in 2013. From July to October the yields were stable although relatively high (averaging 6.1%) as uncertainty continued due to delays in the transfer of non-performing claims and doubts about the

[39] Ministry of Finance.

Table 15: **Ratings (June 2014) and changes between 2008 and 2014**

Country	Agency	As at June 2014	Difference 2014/2008
Greece	Fitch	B	↓9*
	Moody's	Caa3	↓14
	S&P	B-	↓10*
Cyprus	Fitch	B-	↓12**
	Moody's	Caa3 (poz)	↓15**
	S&P	B (poz)	↓10**
Ireland	Fitch	BBB+	↓7
	Moody's	Baa1	↓7
	S&P	A- (poz)	↓6
Portugal	Fitch	BB+ (poz)	↓8
	Moody's	Ba2	↓9
	S&P	BB	↓8
Spain	Fitch	BBB+	↓8
	Moody's	Baa2 (poz)	↓11
	S&P	BBB	↓7
Italy	Fitch	BBB+	↓4
	Moody's	Baa2	↓6
	S&P	BBB (neg)	↓4
Slovenia	**Fitch**	**BBB+**	**↓5**
	Moody's	**Ba1**	**↓7**
	S&P	**A- (neg)**	**↓4**

Source: Standard&Poor's, Moody's, Fitch, 2014.
Notes: * In December 2012 Greece was first downgraded to SD (selective default), whereupon its rating was upgraded in 2013 to B-; ** Cyprus was downgraded to SD in June 2013, whereupon all agencies slightly upgraded their ratings; neg – negative outlook; pos – positive outlook; difference – cumulative rating downgrade in the period.

scope of the capital needs of the banking system. It was not until the completion of bank recapitalisation following the release of the results of bank stress tests and an asset quality review that the yields started dropping substantially. At the end of the year the yield was at 4.39%, but by the end of June 2014 it had dropped to around 3%, the lowest level since Slovenia has been issuing bonds on the euro market. From the second half of 2012 the de-escalation of tensions on financial markets was importantly driven by the stated willingness of the ECB to intervene in the market of euro area bonds. During the course of 2013 all three major rating agencies further downgraded Slovenia's rating (with Moody's reducing it from investment-grade to speculative), although this did not have a significant or lasting impact on the yields. All rating agencies also warned about the debt spike in 2013 in association with bank recapitalisation. At the beginning of 2014 Moody's already improved the outlook to stable, followed by Fitch in May 2014. S&P, meanwhile, changed its outlook from stable to negative in June due to heightened risk regarding the implementation of economic and fiscal policy measures following the government's resignation.

4.2 Projections of general government debt in the Stability Programme 2014

Debt surged last year due to specific transactions associated with the restructuring of the banking system. Owing to uncertainty regarding the time frame and dynamics of these transactions, the SP2013 had not yet made allowance for a EUR 4 bn debt increase that made it possible to transfer non-performing claims from banks onto the BAMC; the bank recapitalisation funds were planned at a much lower level (EUR 1.3 bn).

Under SP2014 projections, overall debt will peak in 2015, whereupon it is projected to decline. In 2015 it will reach EUR 29.4 bn or 81.1% of GDP, but by 2018 it is projected to drop to EUR 28 bn or 70.4% of GDP. From 2016 the debt-to-GDP trend also reflects the expectation that GDP growth will outpace debt growth due to the planned debt and deficit reduction. In the absence of a debt decrease, the debt-to-GDP ratio would stabilise in 2017 (at a higher level), when GDP growth would outpace deficit-driven debt growth. In this case, debt would stabilise in 2017 in nominal terms as well.

Table 16: **Comparison of general government debt and interest expenditure in the SP2013 and SP2014, as a % of GDP**

	SP – Update 2013 (May 2013)					SP – Update 2014 (April 2014)				
	2013	2014	2015	2016	2013	2014	2015	2016	2017	2018
General government debt	61.8	63.2	63.2	61.8	71.7	80.9	81.1	76.0	72.5	70.4
Interest	2.7	2.9	2.8	3.0	2.6	3.4	3.3	3.3	3.1	3.0

Source: Stability Programme (Update 2013), Stability Programme (Update 2014). Note: the projections in the Stability Programme (Update 2013) do not factor in the effects of bank restructuring via the BAMC in the amount of up to EUR 4 bn.

A strong uptick in general government debt is projected in particular in 2014. Debt is projected to increase by EUR 3.5 bn or 9.2% of GDP, which is a consequence of the projected deficit for the year as well as the pre-financing of future liabilities, as the nominal debt increase exceeds the projected combined deficits in 2014 and 2015. Consequently, only a more moderate debt increase (of EUR 0.6 bn) is projected for 2015, a figure lower than the projected deficit for the year. In 2016 and 2017 nominal debt will drop, before it increases in 2018, albeit at a moderate pace.

Debt reduction in 2016 and 2017 is also what underpins the strategy of fiscal consolidation in the SP2014 since it decreases the projected interest on existing debt. The debt reduction under the SP2014 (EUR 1.5 bn) implicitly indicates that privatisation proceeds will be used to reduce indebtedness. The projected debt reduction is feasible given that the National Assembly has approved the sale of 15 companies whose value as at the end of 2013 was estimated at EUR 1.3 bn[40]. Nevertheless, the feasibility of the plan hinges on the pace of privatisation, which had been delayed or abandoned in the past due to problems in achieving political consensus. The state will also receive the proceeds of the bank assets that will be sold by the BAMC[41]. But in order for these processes to proceed smoothly, it will be necessary to strengthen the institutional framework, in particular to ensure the full operability of the recently established Slovenia Sovereign Holding as the manager of state investments. The BAMC and the Bank Stability Fund will also have a key role in privatisation. There has been no decision as yet on the joint management of capital assets held by the SSH and the BAMC, although this will undoubtedly be important given that the two institutions manage and dispose of stakes in the same companies (see also Development Report 2014, Chapter 3.2).

Privatisation could also indirectly affect overall economic activity. Not only will the use of proceeds from the privatisation, as one of the components of consolidation policy, directly affect public debt, its long-term effects on overall economic activity will be even more important, in particular in terms of company performance and development. The share of corporate equity in which the state holds majority stakes increased during the crisis, from 16.4% of overall equity to 23.2% in 2012. Including companies in which the state's stake exceeds a quarter of equity, the share rose to 30% (see Development Report 2014, Chapter 3.2). This places Slovenia among the OECD countries with the highest share of companies in state ownership (OECD, 2013)[42]. The data indicates that Slovenian companies in majority state ownership are typically underperforming compared to other companies in the same industry if measured by productivity, profitability and EBITDA[43]. Their underperformance is particularly clear when it comes to operating profit, which shows they are having problems with their core business. This has been confirmed by foreign and domestic empirical research[44], which shows that privatised companies in transitional economies are more successful, in particular companies privatised by foreign strategic investors. Privatisation could strengthen governance, improve competitiveness and accelerate development, which ultimately results in higher fiscal revenue. It would also strongly reduce the harmful direct interference of politics in the governance of state-owned companies, which has been the cause of poor corporate governance and the suboptimal development of companies.

[40] IMAD estimate; the estimate for listed companies is based on their stock market value as at mid-May 2014, for other companies it is based on the book value of equity from the balance sheets for 2013; the value equity for NKBM is taken from the bank's annual report for 2013. Given the relatively high total value of state equity in firms in which the state has stakes exceeding 50% or 25%, the debt reduction could be even more pronounced.

[41] The Public Finances Act stipulates that all privatisation proceeds be used to pay down public debt.

[42] Among the countries included in the survey, only China (6.00), Russia (5.40), India (5.17), Turkey (4.45), France (4.20), Norway (4.15) and Italy (3.93) were ahead of Slovenia (3.60).

[43] Earnings before income tax, depreciation and amortisation, as one of the benchmarks of a company's efficiency.

[44] Foreign studies of transitional economies include, for example, Mueller, 2003: 373-380; Djankov and Murrell, 2002; Brown, Earle and Telegdy, 2004, 2010; Kočenda and Hanousek, 2009; Jelić, Briston and Aussenegg, 2003; Estrin, Hanousek, Kočenda and Svejnar, 2009; domestic studies include Simoneti et al., 2004; Šušteršič and Rojec, 2010; Rojec and Kušar, 2005.

5 The long-term sustainability of public finances – age-related challenges

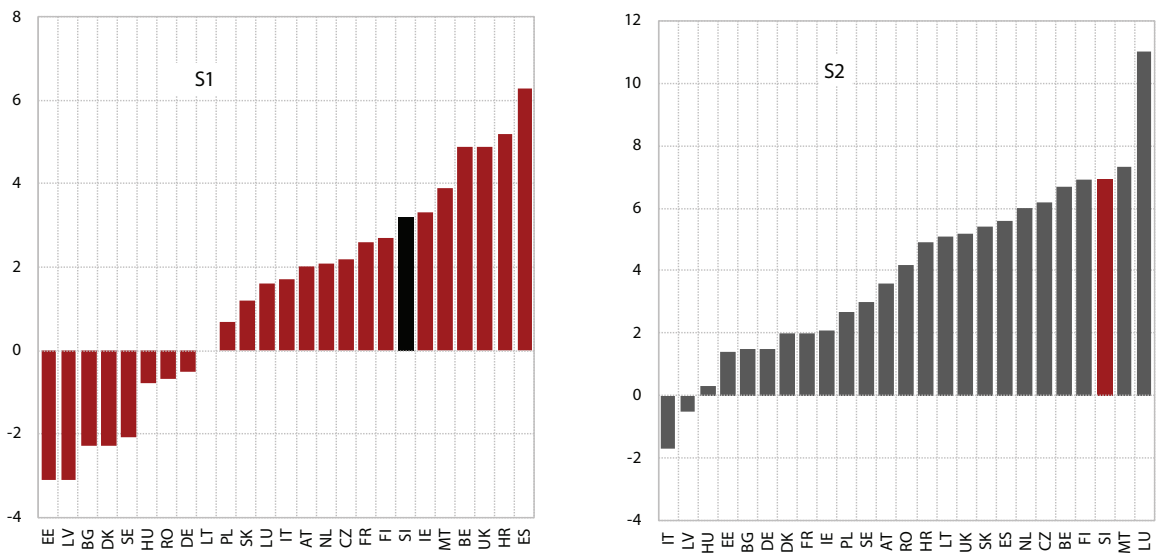
Slovenia is among the EU countries projected to witness above-average increases in the number of the elderly and the old-age dependency ratio by 2060. In March 2014 the Eurostat released new population projections[45] indicating that Slovenia is among the EU countries projected to witness above-average increases in the number of the elderly and the old-age dependency ratio by 2060. The number of persons over 65 is projected to more than double relative to the working-age population (20-64) by 2060[46]. The number of the persons in the oldest age group (over 85), which rose rapidly over the last 13 years[47], will continue to increase (their share will increase from 2% to 7% of the population). The projections suggest that the share of the elderly will grow rapidly already in the period 2020–2030. This will step up the pressure on age-related expenditure, as the demand for pensions, health care and long-term care will increase, whereas the share of the working-age population will contract, creating problems in securing public funds.

The indicators used for monitoring fiscal sustainability in the framework of EU budgetary surveillance indicate high medium- and long-term risk to the sustainability of public finances in Slovenia. Age-related challenges, coupled with the deterioration of public finances and the increase in debt incurred during the economic crisis, have made securing the long-term sustainability of public finances[48] one of the principal goals of economic policies in the EU. There are two main indicators used to monitor fiscal sustainability in the framework of the surveillance of the budgets of EU Member States:

(1) S1 – an indicator of medium-term fiscal sustainability that shows the effort (expressed as the primary balance) required for a Member State to reduce public debt to 60% of GDP as determined by the Maastricht Treaty by 2030. The calculation includes the growth of age-related expenditure (pensions, health care, long-term care) by 2030 in accordance with the latest long-term projections by the European Commission's Ageing Working Group (2012 Ageing Report, 2013).

(2) S2 – an indicator of long-term fiscal sustainability that shows the permanent improvement in the structural balance required to prevent an increase in the debt-to-GDP ratio in the long-term compared to the reference year (2010). The indicator factors in the growth in age-related expenditure by 2060.

Figure 16: **Indicators of medium-term and long-term fiscal sustainability – S1 and S2, Slovenia and EU countries**



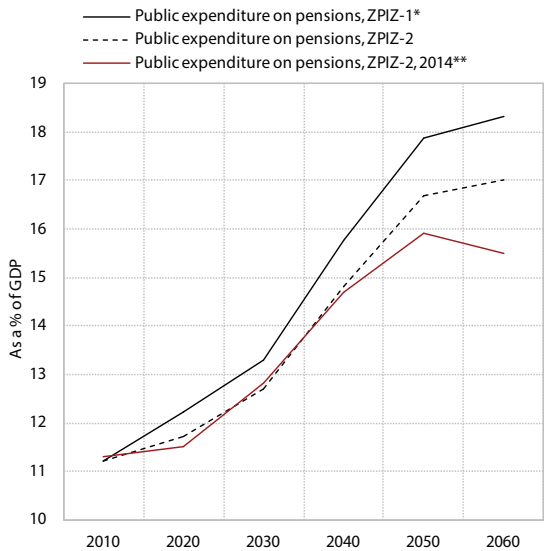
Source: A Thematic Assessment Framework for Structural-Fiscal Reforms, January 2014.

[45] See also Slovenian Economic Mirror, April 2014, Selected topics – EUROPOP2013 population projections.
[46] At the beginning of 2013 there were 26.9 over 65-year-olds dependent on 100 working-age people; by 2060 the figure will rise to 58.3 (EUROPOP2010: 63.4).
[47] At the beginning of 2013 the number of such in Slovenia had increased by over 60% compared to 2000.
[48] The notion of the sustainability of public finances refers to a country's ability to sustain the existing tax policy and the provision of public services without increasing the debt-to-GDP ratio (EC, 2014).

In January 2014 the European Commission released new values of the indicators S1 and S2 based on partially updated long-term projections from 2012 (A Thematic Assessment Framework for Structural-Fiscal Reforms, TAF, 2014). Even factoring in the effects of the pension reform[49], both indicators still place Slovenia among the countries with a high risk to the sustainability of public finances (S1: the required fiscal effort is 3.2% of GDP; S2: 6.9% of GDP). The group with high medium-term risk (S1 greater than 2.5) includes Slovenia and eight other EU countries, while the group with long-term risk (S2 greater than 6.0) comprises six countries in addition to Slovenia.

The main risk to the sustainability of public finances in Slovenia is the rapid growth in pension expenditure; financing of pension expenditure will become constrained after 2020 since last year's pension reform only modestly mitigated the pressure on public finances. Pension expenditure[50] rose rapidly in the period 2010–2013 (by 2.5% per year on average and by 4.1% for old age pensions). Prior to the adoption of the new pension legislation, the Ageing Report (EC, 2012) projected that pension expenditure as a share of GDP would start growing rapidly before 2020 and expand at an above-average rate compared to other Member States by 2030, whereupon the problem would further deepen in the second part of the period until 2060. The new act only defers the increase somewhat and reduces expenditure as a share of GDP by slightly over one percentage point. Even under the new EUROPOP2013 projections, which are slightly more favourable in terms of the share of the elderly than the previous projections (EUROPOP2010), the estimates of pension expenditure in the Stability Programme 2014 still highlight that problems with the financing of age-related expenditure[51] will appear in the medium term already.

Figure 17: **Comparison of pension expenditure in 2010–2060, ZPIZ-1 and ZPIZ-2**



Source: Country fiche, April 2013; Stability Programme 2014. Note: * Under the new demographic projections in Europop2013, the projections of pension expenditure would have been lower under the ZPIZ-1. ** The ZPIZ-2 taking into account the new demographic projections in Europop2013.

In its first year of implementation it was not possible for the pension reform to result in tangible (financial) effects considering the spike in retirement prior to its entry into force and the transitional periods; indeed, the pressure on financing from the state budget actually increased. As the reform took effect as of 2013, the number of requests for retirement dropped considerably (40% fewer requests for old age pensions). Aside from the stricter retirement criteria, this was also a consequence of the high number of requests for retirement under the previous act (ZPIZ-1) in 2012. The surge in retirement at the end of 2012 nevertheless led to an increase in the number of pensioners at the beginning of 2013 (individuals are formally classified as pensioners when they receive their first pension). The impact of the pension reform on retirement age[52] will be gradual, as the ZPIZ-2 determines multiple transitional periods. Additionally, given the increase in unemployment in recent years, we assume that a considerable number of the unemployed will retire in 2014 under the ZPIZ-1 and hence at a lower age.[53] Last year's rapid increase in the number of pensioners after the adoption of the ZPIZ-2 (2.8%) significantly exceeded the rate planned in the Financial Plan of the Pension and Disability Insurance Institute (ZPIZ)[54], which increased the pressure on the national budget. Budgetary transfers to the ZPIZ rose 11.9% in nominal terms to EUR 1,584.8 m (32% of overall ZPIZ revenue).

[49] The Pension and Disability Insurance Act (ZPIZ-2), Official Gazette RS, No. 96/2012. The legislation was adopted on 4 December 2012 and entered into force as of 2013.

[50] According to the Ministry of Finance's ZPIZ balance sheet, which includes these types of pensions: old-age, disability and family pensions, farmers' pensions, veterans' 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.

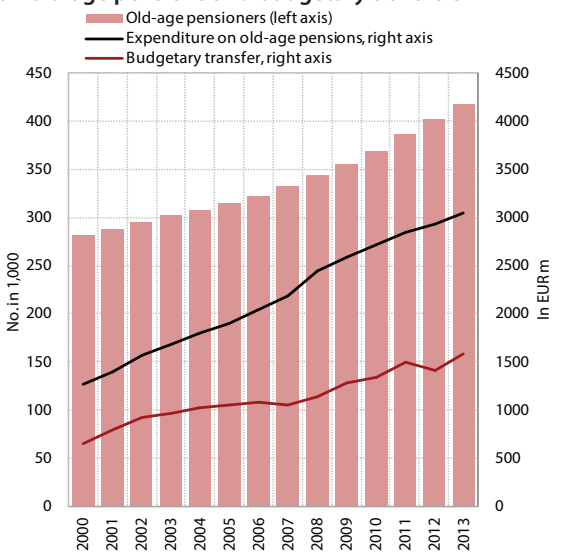
[51] A new Ageing Report that includes new population projections will be released by the EC in early 2015.

[52] See Economic Issues 2013, p. 35.

[53] In accordance with the ZPIZ-2 (Art. 394), individuals who received unemployment benefits or did public works as at 31 December 2012 may retire under the conditions valid at the time. An individual eligible for the longest benefits (25 months for those over 55 with over 25 years of contributions) who became unemployed in December 2012 will probably retire by January 2015.

[54] Total pension expenditure exceeded the projections of the ZPIZ Financial Plan by EUR 49.1 m.

Figure 18: **Number of old-age pensioners, expenditure on old-age pensions and budgetary transfers**

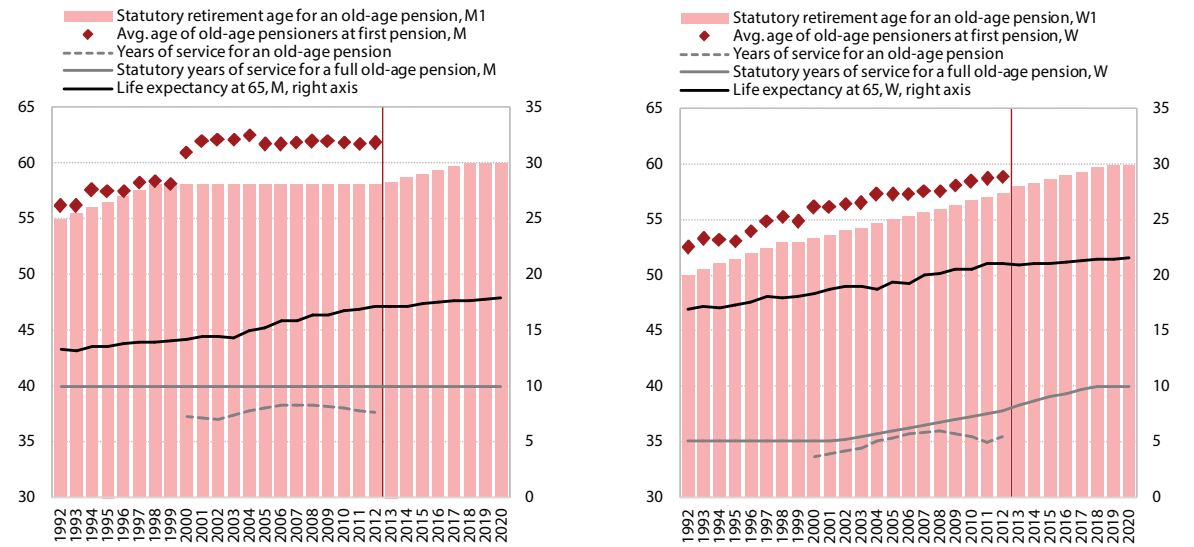


Source: Ministry of Finance, ZPIZ.

The amended financial plan for 2014 and the plan for 2015 assumed budgetary transfers of EUR 1,511.6 m and EUR 1,481.5 m, respectively, and EUR 190 m each year from Kapitalska družba[55].

A proposal to link the retirement age to life expectancy is gaining currency at the EU level due to increasing life expectancy and the resulting extension of years in retirement. Many countries have been raising the retirement age as life expectancy increases and the population ages. Almost a half of all EU countries have raised the retirement age to 65 or over for both men and women[56]. Meanwhile, proposals to link the retirement age to life expectancy are increasingly gaining currency, as this would adjust the share of a lifetime spent in retirement and dam expenditure growth. This mechanism represents an effective way of increasing the sustainability of pension systems and it has a positive impact on the provision of adequate pensions given that individuals working longer get higher pensions (EC, 2012). The

Figure 19: **Statutory and average retirement age, years of pensionable service and life expectancy at retirement for men (left) and women (right)**



Source: ZPIZ, Eurostat, Pension and Disability Insurance Act (Official Gazette RS, Nos. 12/1992, 106/1999, 109/2006, 96/2012).
Note: The average retirement age is higher than the statutory age, as individuals were unable to retire on full pensions at the statutory age due to insufficient years of service; M1/W1 1997-1999: the data is for December; the data for 2000-2002 is for old-age pensioners (under general and special acts), the data from 2003 is for old-age pensioners retired under the general provisions of the ZPIZ-1; M2/W2 statutory retirement age at the completion of the required years of service (which is different depending on the act and on the year); M3/W3 data from 2003 is for old-age pensioners retired under the general provisions of the ZPIZ-1.

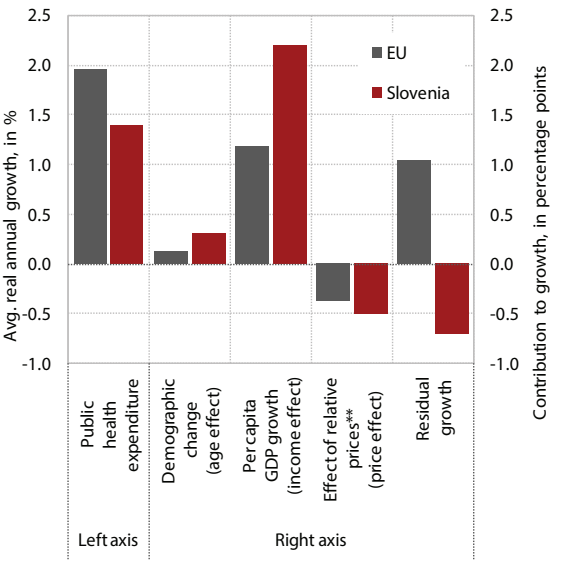
[55] The Financial Plan for 2013 assumed EUR 120 m of funds from Kapitalska družba (up from EUR 50 m in the previous years), but the conditions were not fulfilled; under the Budget Implementation Act for 2013 and 2014, Kapitalska družba is entitled to 10% of proceeds from the sale of state-owned financial assets and state financial assets of at least EUR 700 m were planned to be sold (Government of the Republic of Slovenia, 2013; Official Gazette RS, 104/2012).
[56] MISSOC data. Slovenia is included since this is the statutory retirement age, not the actual retirement age. Moreover, the minimum age of retirement may differ in different periods due to different pension systems and, in Slovenia's case, transitional periods.
[57] The retirement age is being gradually raised based on increased life expectancy. The mechanism was first used in 2013 and the retirement age will be adjusted to life expectancy every three years (EC, 2012). In January 2021 the retirement age will have to be at least 67, by 2050 it is projected to reach 69 years and 9 months (MISSOC).
[58] The statutory retirement age will be adjusted to gains in life expectancy every five years (Country Fiche, 2013).
[59] From 2021 the retirement age will be adjusted to changes in life expectancy; the first adjustment will be made based on the change over the period 2010–2020 (EC, 2012).

mechanism is currently in use in Italy (since 2013[57]); Slovakia (2017), Cyprus (2018[58]), Greece (2021[59]), the Netherlands (2024[60]) and Spain (2027[61]) have signed it into law but deferred its implementation.

The EC has already made analyses of the impact of the mechanism, including for Slovenia. These take into account different scenarios to link retirement age to life expectancy: (i) the current statutory retirement rate increases fully in line with gains in life expectancy, (ii) the current statutory retirement age increases fully in line with a 66% share of the expected increase in life expectancy, (iii) the effective retirement age increases so that the relative share of life spent in retirement remains constant in the period 2010–2060; or (iv) by 2060 the share of a lifetime spent in retirement approaches the EU-27 average in 2010 (23% for men and 27% for women) (Schwan and Sail, 2013). EC calculations for Slovenia show that by 2060 life expectancy at 65 would be 21.9 years for men and 25.3 years for women (The 2012 Ageing Report, 2012). This would mean an increase in life expectancy in 2020–2060 of 4.3 and 4.0 years, respectively, assuming that all transitional periods under the ZPIZ-2 expire by then and the retirement age reaches 65. A simple calculation shows that the retirement age would have to be 69 by 2060 if the retirement age increases fully in line with expected gains in life expectancy, and close to 68 if it increases in line with a 2/3 share of the expected increase in life expectancy. Similar results are also stated in the EC report (Schwan and Sail, 2013), where the calculation takes into account the effective retirement age, which in Slovenia was 60.9 years in 2011 and would be 4 years more assuming a full adjustment to life expectancy gains.

The growing expenditure on health and long-term care, driven by demographic and non-demographic factors alike, also poses a significant risk to the long-term sustainability of public finances. Demographic factors affect the growth of health and long-term care expenditure alike, but in health care in particular the effect of non-demographic factors[62] is stronger. Factoring in the effect of these factors on growth in health and long-term care expenditure, international institutions have formulated several scenarios in recent years involving increases in such expenditure by 2060, which serve as warnings to countries to improve the efficiency of health and long-term care systems if they want to preserve the current level of accessibility and quality of health care, and meet the demands of ageing populations for long-term care (Medeiros J. et al., 2013; Maisonneuve C., et al., 2013; Clements B., et al., 2012). However, in Slovenia the contribution of the residual growth[63] of non-demographic factors was negative in the past. This may indicate that growth in public expenditure on health care is being managed (strong budgetary constraints, control of prices of pharmaceuticals, low employment growth), but it could also be a consequence of a sluggish introduction of new technologies, poor equipment, and mounting delays in improving the capacity of public health care. Additionally, the negative contribution of these factors in Slovenia was made possible by the shifting of the financing of the growing health care needs onto complementary health insurance.

Figure 20: **The contribution of demographic and non-demographic factors to growth in per capita public health expenditure, 1995–2010, Slovenia and the EU average**



Source: Medeiros J., Schiwierz C. (2013).
Note: * Assuming income elasticity of 0.7; ** Assuming price inelasticity of demand for health care services of -0.4.

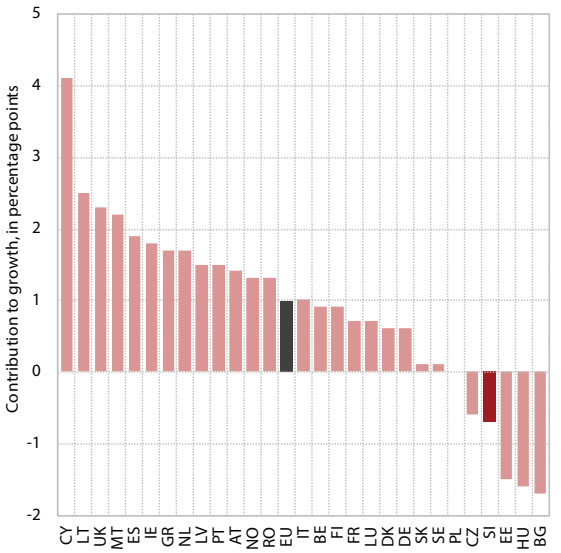
[60] In 2023 the retirement age is to reach 67, whereupon it will be linked to life expectancy gains (MISSOC).

[61] The retirement age will be adjusted to life expectancy gains every five years, the starting age being 67 (EC, 2012).

[62] Non-demographic factors in health care include growth in per capita GDP and relative price growth, which is higher in health care due to specifics of activities (the introduction of technological solutions does not reduce the demand for labour, it often increases it) as well as technological progress, the institutional characteristics of health care systems, health policy, employment growth, educational structure, and the social environment and values. In addition to GDP growth and changes in the relative prices of long-term care services, non-demographic factors in long-term care include assumptions about the transition from informal to formal care, and increasing expenditure per beneficiary of long-term care.

[63] In its studies the European Commission uses the term residual growth in per capita health expenditure exceeding growth in per capita GDP after other factors (demographic change and the effect of relative prices) have been controlled for. The OECD and IMF define this as excess cost growth.

Figure 21: **Contribution of residual growth to average growth in per capita public health expenditure, 1995–2010, Slovenia and other EU countries**



Source: Medeiros J., Schiwierz C. (2013).

Long-term scenarios formulated by international institutions warn that in the long term Slovenia will have to increase health and long-term care expenditure as a share of GDP, showing that the pressure on public finances will increase strongly if current policies remain in place. The EC and the OECD have formulated two scenarios of expenditure growth (the OECD for health and long-term care, the EC just for health care): (i) a cost-containment scenario assuming that health policy will manage pressure on expenditure growth with appropriate measures, and (ii) a cost pressure scenario assuming that current policies will continue. EC projections show that under the first scenario health care spending would increase by nearly a third by 2060 despite the adopted measures (in Slovenia by 3.3 percentage points to 9.9% of GDP; EU average by 2.8 percentage points to 9.3% of GDP); under the second scenario it would almost double (in Slovenia by 5.9 percentage points to 12.5% of GDP; EU average by 5.2 percentage points to 11.7% of GDP). OECD projections assume even faster growth in health expenditure in the absence of policy change. They also show that public expenditure on long-term care would more than double by 2060 under the cost-containment scenario[64] and triple in the absence of policy change[65].

[64] Assuming that expenditure per beneficiary increases only at half the rate of labour productivity growth.

[65] Assuming that future expenditure per beneficiary grows in line with aggregate labour productivity.

The EC and OECD have also been warning about the risks of stop-and-go[66] policies. Slovenia as well as the majority of other countries have in recent years been restraining health expenditure growth only with savings measures such as reigning in wage growth, controlling the growth of pharmaceutical prices and deferring investments, measures that cannot be successful in ensuring sustainability in the long-term. Past austerity periods have always been followed by periods of rapid expenditure growth (wages need to grow to draw young doctors into the profession; reducing the prices of pharmaceuticals and new technologies is a major challenge due to fast progress, investments in equipment are urgent). In order to enhance the fiscal sustainability and efficiency of health care systems, the EC thus recommends the following (Report on Public Finances in EMU 2013): (i) ensuring a sustainable financing system that needs to be adaptable and predictable in times of economic crisis (broadening the contribution bases and raising the contribution rates, increasing budgetary financing with new taxes/excise duties, strengthening automatic stabilisers, improving the collection of taxes and contributions); (ii) changing the scope of rights stemming from compulsory health insurance and the scope of co-payments for services and pharmaceuticals taking into account the criteria of accessibility, efficiency and cost effectiveness[67]; (iii) strengthening the primary level and the system of gatekeepers[68] to prevent unnecessary use of expensive specialist ambulatory treatment and hospital care; (iv) price regulation of pharmaceuticals and medical devices; (v) raising investments in health promotion and increasing excise duties on tobacco, alcohol and beverages with high sugar content[69]; (vi) introducing the method of health technology assessment (HTA) to prevent investments in inefficient treatment procedures, and investing in e-health.

The problem of ensuring the long-term sustainability of financing health and long-term care systems in Slovenia has also been highlighted in a study by the Institute of Economic Research. In March 2014 the IER

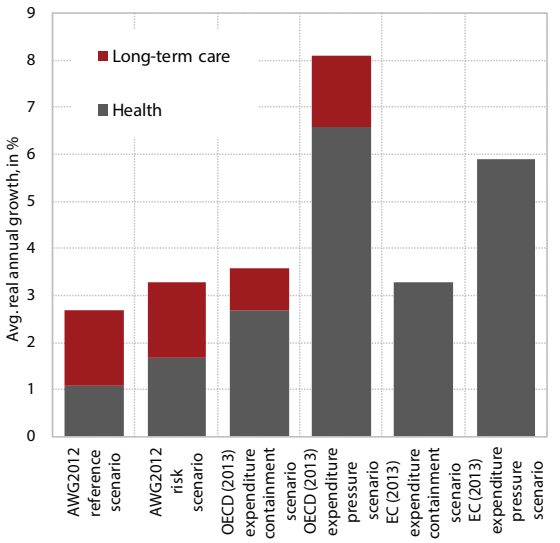
[66] An approach to fiscal consolidation that favours stop-gap measures (instead of structural measures), which are typically unsustainable in the long term and cause imbalances, requiring that they be abolished at a later time.

[67] The EC warns that curtailing rights and increasing co-payments may result in higher expenditure in the long term in the event these measures defer treatment and consequently worsen medical conditions, requiring emergency care or shifting care to higher (more expensive) levels of health care.

[68] At the primary level, general practitioners act as gatekeepers by reducing the scope of more expensive specialist ambulatory treatment.

[69] These measures reduce the burden of chronic diseases and constitute a key policy in the long-term reduction of health care expenditure.

Figure 22: **Long-term projections of growth in health and long-term care expenditure, 2010–2060, comparison of scenarios**



Source: The 2012 Ageing Report (2012), Maisonneuve C. and Martins O. (2013), Medeiros J. and Schwierz C. (2013).

presented a comprehensive assessment of potential sources of health care financing using an adapted version of the microsimulation pension model. The study (Majcen B., Čok M., 2014) found that assuming the growth in health expenditure under the reference AWG scenario (The 2012 Ageing Report, 2012)[70] and the projections of current fiscal sources for health care, a long-term deficit will build up, reaching 0.43% of GDP by 2025 and 1.43% of GDP by 2060. Just to cover the deficit in 2025 the contribution rate for mandatory health insurance would have to rise by 1.2 percentage points (whereby Slovenia already ranks close to the top among EU countries in terms of the burden of social contributions, while the employee contribution rate, at 22.1%, is among the highest in the OECD) or other sources of financing would have to be secured. The IER further warns that the active population, which under the current system finances almost all social contributions, will not be capable of carrying this financial burden in the long term; reform designed to ensure the sustainability of the health care system and the preservation of accessibility will therefore have to extend beyond the sources of financing. Additionally, health care reform needs to be carried out along with the establishment of a system of long-term care and changes in the pension system.

[70] As in the European Commission's Ageing Working Group the main purpose of reference scenarios is to warn about the growth in age-related expenditure, this scenario only partially factors in non-demographic factors (it assumes income elasticity of 1.1, which also takes into account the impact of all other non-demographic factors).

6 Fiscal policy challenges

Prior to the start of the economic crisis Slovenia pursued a fiscal policy that was structurally imbalanced and unsustainable even over the medium term. The general government deficit had been contracting before the crisis and in 2007 Slovenia had a balanced general government position. But these trends were driven by factors inherent to the economic cycle, not appropriate structural changes. Tax reforms in 2006 and 2007 had a significant and lasting effect on the weakening of general government revenue in the subsequent years, as the tax changes were not matched with other measures to offset the shortfall (e.g. the broadening of the tax bases). These changes were positive in shifting taxation from labour and capital to consumption, but Slovenia nevertheless remains among the countries with above-average marginal income tax rates, which is problematic in terms of financial incentives for employees (in particular, highly educated workers). Whereas taxes were cut, there were no expenditure-side measures (permanently) reducing spending. Indeed, until 2011 expenditure continued to rise. After 2007, pension expenditure in particular increased strongly, as did the budgetary transfer required for the provision of the rights stemming from pension insurance.

Against the backdrop of the effect of automatic stabilisers and the bailing out of the banking sector and state-owned companies with recapitalisations, these structural weaknesses led to a substantial deterioration of public finances during the crisis. The severe downturn in 2009 coupled with the effect of automatic stabilisers severely disrupted the balance of public finances in 2009 (-6.3% of GDP). Additionally, fiscal stimulus measures equivalent to about 2% of GDP were adopted to mitigate the effects of the crisis in the first years of the crisis. Until 2011 the deficit remained at a high level of about 6% since consolidation did not start until 2012, when the deficit dropped significantly for the first time since the beginning of the crisis. In recent years, expenditure growth was also driven by the recapitalisation of state-owned companies and banks and the absorption of the debt of certain companies, which totalled 12% of GDP in 2010–2013. The belated and inadequate response to the crisis in its initial stages now requires an increased fiscal effort to reduce the deficit below 3% of GDP by 2015 and balance public finances in 2017/2018.

Fiscal consolidation is thus among the key economic policy challenges in the coming years and it needs to be implemented with measures that will improve

the sustainability of public finances in the long term and improve their resilience to new shocks. The fulfilment of commitments at the EU level requires a continuation of the fiscal consolidation started in 2012. In addition to the restructuring of the banking system and deleveraging of companies, this is the key economic-policy challenge that will improve the stability of the macroeconomic environment for Slovenian businesses as the necessary basis for a return to growth and development. Failure would mean that Slovenia could once again face strongly constrained access to financing on international financial markets and a deterioration of its economy. The fiscal policy challenges need to be addressed with measures with a more lasting effect, which is the only way to ensure the sustainability of public finances in the long term.

Owing to the slow economic recovery and the limited scope to raise taxes, fiscal policy is confronted with the challenge of continuing the consolidation by lowering expenditure and adjusting it to the capacity of the economy. In doing so, it will have to focus to a greater extent than thus far on achieving consensus on measures with more lasting effects that will also be a result of a substantive debate on financing society's priorities. An international comparison of the taxation of labour and consumption shows there is little scope to raise these taxes, but there are possibilities to raise additional revenue with better tax collection, broadening of the tax bases, and changes in the taxation of property (real estate). Sorting out the taxation of real estate would also have a positive impact on spatial planning policies and the real estate market. However, revenue-side measures are sensible only as support measures in an economic policy mix in which expenditure cuts need to play the key role. It is important that restricting or cutting expenditure be achieved with structural changes and only to a lesser extent with the contraction of investment activity and linear measures that are not viable in the long term. This requires a detailed overview of expenditure and the expansion of planning in accordance with programming classification, as well as a programming approach to budgetary planning that would also allow for a more substantive debate on the channelling of limited public resources to priority areas. In the absence of serious structural adjustments, continued linear cutting of expenditure in certain segments can 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 a part of the services currently provided by the public sector onto the private sector.

The fiscal policy outlined in the Stability Programme 2014 does not provide a comprehensive and entirely appropriate answer to these challenges. The consolidation strategy in the SP2014 may achieve the objectives that Slovenia is pursuing in the framework of the excessive deficit procedure, i.e. bringing the deficit below 3% of GDP in 2015, but even in the short term the achievement of these objectives could be rendered difficult considering the existing approach to consolidation, which is not entirely adequate or based on the timely adoption of measures with more lasting effects. To achieve the revenue and expenditure targets the SP2014 proposes certain measures that require legislative changes which may be delayed because of the early election, whereas the measures to achieve some of the objectives have not even been defined yet. Risks to the achievement of the target revenue stem from the poorly defined and potentially unsustainable level of increases in various non-tax revenue that are expected to offset the shortfall of revenue from the real estate tax and the crisis tax. Such sources are not systemic fiscal sources and are therefore considered less reliable. Additional revenue risks in the coming years are also associated with possible divergence from the projected trajectory of economic recovery, which could effect the level of tax revenue. On the expenditure side, there are short-term challenges regarding the reduction of labour costs in the private sector, subsidies and intermediate consumption expenditure. In 2014–2016 consolidation focuses strongly on reducing these kinds of expenditure, but some of the proposed measures will require legislative changes. Moreover, the target reduction in compensation of employees will also depend on the results of negotiations with social partners, which are still ongoing. The currently planned measures to reign in these expenditure categories also preserve too much of the existing linear approach to cost-cutting. This approach can ensure the achievement of the objectives, but it may also have many negative consequences (the weakening of the quality of public institutions, the provision of public services, disincentivising wage system) for which solutions are not indicated. Further expenditure-side risks are associated with the viability of stabilising interest expenditure at the level planned in the SP2014. To stabilise interest expenditure by 2018, it is essential that the consolidation strategy be implemented consistently with the plans across the entire programming period and that the deficits do not exceed the projections. Furthermore, a key consolidation element over the medium term is the privatisation of state-owned companies, which would contribute to the reduction of public debt and hence interest expenditure after 2016. In the event of delays, interest expenditure would crowd

out other expenditure to an even greater extent than currently projected. Given that some revenue- and expenditure-side measures have not been defined, there is a risk that the level of investments projected for the individual years will not be realised. To a certain degree, the projections of investments create some leeway for the reduction of this type of expenditure in the event that there are problems in achieving the planned level of other expenditure or revenue, and hence the target deficit. However, this would undermine the role that state investments could play in stimulating economic growth.

The gradual correction of the deficit and the production of a surplus in the medium term will also stem the growth of public debt, although it will be a great challenge to reduce it as planned with proceeds from the privatisation of state-owned companies. The debt increase in the last five years, which totalled 50 percentage points to reach 71.7% of GDP, has taken Slovenia in a relatively short period from the group of EU countries with low debt to the group of counties with medium indebtedness. The pace of the increase and the resulting rapid rise in interest expenditure in a relatively short time, coupled with the fiscal effort required to reduce the general government deficit, is creating strong pressure on the structure of general government expenditure and increases the need for rapid adjustment. The only way to stem the rising debt is to form surpluses, with the SP2014 additionally projecting a reduction of debt post-2016 with the use of privatisation proceeds. It is our assessment that this would contribute not only to consolidation and debt sustainability, and reduce the crowding out of other expenditure categories that could be leveraged to promote economic growth, but it could also indirectly affect overall economic activity by improving corporate governance and reducing fiscal risks. therefore constitutes a key component of future economic policy.

In the long run, fiscal risks and challenges stem primarily from the projected ageing of the population and the attendant adjustment of the systems of pension insurance, health and long-term care. The biggest risk to the sustainability of public finances is the rapid growth in pension expenditure. The problem of covering pension expenditure is already pertinent and has in recent years required increasing transfers from the national budget; after 2020 it will only get worse. The last pension reform only somewhat deferred the projected increase in pension expenditure and reduced its share of GDP by just over a percentage point. Studies also show that current health and long-term care policies are unsustainable. In recent years health expenditure has been curbed chiefly by austerity measures such as the slowing of wage growth, the lowering of drug prices, and the deferral of investments, but such measures cannot be sustainable in the long term. In health care, the challenge will therefore be to put in place long-term systemic changes, but these need to be enacted concurrently with the establishment of a system of long-term care and changes to the pension system.

In achieving the commitments, fiscal policy can also be aided by a more robust and credible institutional framework. Slovenia has not succeeded in recent years in strengthening the institutional framework of fiscal policy. In May 2013 the National Assembly endorsed amendments to the Constitution introducing a balanced budget rule, which was to be followed within six months by the implementing act. The Act on Public Finances should have been changed as well to adjust the procedure for budgetary planning and the adoption of supplementary budgets. These changes have yet to be carried out. In order to preserve the credibility of the country, it is necessary to adopt the implementing act in due time, but it is also important that the act take into account the current extraordinary economic circumstances. Considering that the implementing act on the fiscal rule has been delayed, the operation of the Fiscal Council, an independent institution assessing fiscal policy plans, has yet to be resolved as well. Additionally, the role of other institutions which have been weakened in recent years (public administration) will have to be enhanced going forward. Only then can they act as competent interlocutors in the EU (in the framework of EU institutions), whose role in the planning and implementation of policies that are in the jurisdiction of Member States has been increasing.

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II.
Labour market performance and challenges during the crisis

Summary

The labour market situation in the EU and Slovenia is still a great deal worse than before the crisis. The decline in economic activity triggered a labour market adjustment in the EU, the bulk of the adjustment taking place by reducing employment. In 2013 the employment rate in the EU (the population aged 15–64 years) was 1.6 percentage points lower, on average, than in 2008. In Slovenia, the employment rate dropped substantially more in this period (by 5.3 percentage points) due to the greater decline in economic activity and structural weaknesses of the Slovenian economy. For this reason a number of EU countries, including Slovenia, drifted away from the Europe 2020 national employment rate targets in 2008–2013.

Countries responded to the deterioration of the labour market situation by strengthening active labour market policies and labour market reforms. In 2009 expenditure on active labour market policies had been stepped up across the entire EU, but in 2010 and 2011 it was already reduced in some countries due to fiscal consolidation, despite the further deterioration of the labour market situation. At the beginning of the crisis Slovenia responded to the tightening labour market conditions by passing two intervention laws to preserve jobs and stepping up active labour market policies (ALMPs), but later on it turned to more passive measures to mitigate the impact of the crisis. After falling in 2011 and 2012, the number of unemployed participating in ALMPs rose in 2013. Given that the adjustment capacity of the labour market – which is significantly impacted by labour market institutions – became very important during the crisis, a number of countries also carried out labour market reforms. The number of reforms in the areas of employment protection, unemployment insurance and active employment policy thus increased in the EU in the period of the crisis. Slovenia made several changes in the area of unemployment insurance in this period. In April 2013 it also enacted changes to employment protection, which have been another important factor in labour market adjustment.

In the 2008–2013 period, in both the EU and Slovenia employment opportunities dropped substantially, particularly for youth, men and low-skilled people. During the crisis, job prospects for young people and men in particular deteriorated in Slovenia and the EU overall due to a sharp decline in activity in the construction and manufacturing sectors. This was also reflected in a sizeable decline in the job prospects for low-skilled workers. The significant deterioration of the situation of young people on the labour market in the EU was related to the above-average prevalence of temporary employment among the young (non-renewal of fixed-term employment contracts as a frequently used way of reducing employment in companies). Against the backdrop of tightened labour market conditions and modest demand, young people also find it more difficult to find a job due to their lack of experience. The decline in job opportunities for young people in Slovenia was also related to the fall in student work (by more than a third in 2008–2013, in addition to lower demand for work, also due to a rise in concession fees on student work), a significant increase in the number of graduates in recent years and a mismatch (in terms of field of study) between the supply of tertiary-educated graduates and labour market demand.

The rising long-term unemployment and the problems of young people seeking work are the key labour market issues in Slovenia. As a result of low economic activity and, consequently, poor job prospects, an increasing share of the active population is remaining unemployed for longer and longer periods of time. The long-term unemployment rate more than doubled and the very long-term unemployment rate almost tripled in 2008–2013, which is a sign of increasing structural problems. The relatively strong growth in the number of very-long-term unemployed (over 24 months) seen in the last two years is particularly worrying, as it diminishes the possibilities for reducing unemployment in the next few years and increases the likelihood of the transition of unemployed people into inactivity and migrations. Furthermore, the employment problems of young people are also increasing. Despite the high participation of young people in education, the share of unemployed youth in the total youth population (15–25 years) rose from 4.5% in 2008 to 7.3% in 2013, and the share of youth not in employment, education or training (the NEET rate) from 6.5% in 2008 to 9.3% in 2012.

Labour market segmentation and the low employment rate of older people represent another serious problem in Slovenia. Labour market segmentation manifests itself in a high share of temporary jobs among youth – in Slovenia it is the highest in the EU. The major share of youth employment is accounted for by fixed-term employment and other types of flexible work, notably student work. The Slovenian labour market is not just segmented by type of employment, it is also segmented by age. Like the employment rate of youth (15–24 years), the employment rate of older people (55–64 years) is low in Slovenia, the lowest in the EU. In addition to the effects of early retirement in the past, this is related to certain barriers to employment for older people, which can also be attributed to systemic reasons. The pension reform, which entered into force in 2013, will contribute to a gradual increase in the employment rate of older people in the coming years. As to the tax allowances for hiring or retaining older employees – given the different definitions of these allowances in different laws, it will be necessary to reconsider their level and check if all of them are rational.

The reforms in labour market regulation in 2013 were focussed on reducing segmentation and increasing flexicurity. In April 2013 the Employment Relationship Act (ZDR-1) and the Act Amending the Labour Market Regulation Act (ZUTD-A) entered into force, the main goals of the adopted reforms being: (i) reducing labour market segmentation; (ii) increasing flexibility; and (iii) increasing legal protection of employees. The majority of changes aimed at reducing segmentation pertained to: (i) reducing the gap in firing costs for workers with fixed-term and permanent employment contracts; (ii) simplifying the termination procedures for permanent employment contracts; and (iii) limiting the possibilities for using repeated (chain) fixed-term contracts. The reforms aimed at increasing labour market flexibility involved changes towards reducing employment protection, mostly by lowering severance pay, shortening notice periods and simplifying the termination procedures for fixed-term employment contracts. Moreover, the possibility of time-limited or occasional work for pensioners was introduced, but employers used this only modestly in the initial period, even though it allows more flexibility.

Analysis of labour market conditions indicates that last year's changes to regulations contributed towards achieving the set goals. Changes in the area of regular employment protection, which declined substantially (below the OECD average), were focused on increasing flexibility. The reallocation rate of the unemployed (inflow in, and outflow from, registered unemployment compared with the average number of the registered unemployed), which is an indicator of flexibility, rose slightly. After the changes took effect, permanent employment started to increase more rapidly than fixed-term employment. The share of newly created permanent jobs in the total number of new jobs has increased since the adoption of the changes, which indicates a shift towards reducing labour market segmentation. Last year's reform in labour market legislation was a move in the right direction, but a further monitoring of its effects on the labour market is essential, as they are difficult to identify in the relatively short period since adoption. The increase in the share of self-employment and other types of employment after the adoption of changes, amid a decline in the share of permanent employment, shows the need for Slovenia to address the issue of economically dependent people and reconsider the usefulness and effectiveness of the different types of existing tax incentives for self-employment.

Another challenge in reducing labour market segmentation is a change in student work regulation. Last year's labour market reform did not interfere with the system of student work, although student work also needs to be reformed in order to reduce labour market segmentation. Student work should be more closely tied to gaining experience, which would have a positive effect on the career paths of students/pupils and facilitate their transition from education to employment. Student work should also be included in the social security system. However, finding a solution that would not excessively limit student work is a challenge, as this could significantly exacerbate the indicators of the situation of young people on the labour market and limit the possibilities of using flexible work arrangements for employers.

In view of the significant structural problems on the labour market, strengthening and increasing the efficiency of ALMPs also represents a challenge. Slovenia is one of the EU countries with the lowest expenditures on active employment policies relative to GDP. In light of the increase in structural problems and the at-risk-of-poverty rate among the unemployed, it would be sensible to step up the ALMP programmes and increase their effectiveness. The participation rates of unemployed people over 50 years old and low-skilled people in ALPMs otherwise increased the most in 2013, but they are still relatively low. Given the rise in very long-term unemployment, it would be sensible to design and broaden programmes that prevent transition into long-term unemployment and on-the-job-training programmes that have proved the most effective in evaluation studies for other countries. It is, however, also necessary to create a system of independent evaluations of the effects of individual ALPMs in Slovenia and take them into account in the implementation of programmes. To reduce structural imbalances, in the short term, it would be sensible to increase the role of ALMPs in the area of education and training, which would better match employer needs. However, for a more systematic solution, it would be necessary to establish a system for monitoring and forecasting employers' demands for skills and knowledge in the short and long term. Given that the incentives for hiring young people are governed by several different laws and ALMPs, the level and form of these incentives should be reconsidered from the perspective of effectiveness. Increasing employment prospects for the young requires effective implementation of the Youth Guarantee scheme financed by funds to support youth employment at the EU level.

Increasing employment and improving the capacity to adapt to changes in the economic environment are also significant challenges to economic policy in the area of the labour market. The key factor in improving labour market conditions is the recovery of economic growth. Alongside the continuation of structural reforms, the efforts should be focused on fiscal consolidation, effective stabilisation of the banking system, creating a stimulating business environment and attracting foreign investment. Improving competitiveness will require further reforms, not only in the area of employment, which was tackled by last year's reforms, but also in the wage-setting system, including the minimum wage policy, and in the area labour taxation, including the introduction of appropriate work incentives.

Introduction

The labour market in Slovenia is gradually adjusting to the circumstances brought about by the economic crisis and to last year's labour market reform. The decline in economic activity has triggered a process of labour market adjustment to the lower level of activity. Slovenia is one of the countries that recorded the largest declines in economic activity in 2008–2013. The labour market in Slovenia adjusted to the lower level of activity mostly by a substantial reduction in employment, which exceeded the EU average but was not among the largest in the EU. In our estimation, this was also attributable to the intervention measures taken to preserve jobs, which were in effect in 2009 and 2010, and the relatively strong employment protection until April 2013. Since then, labour market trends in Slovenia have also been influenced by changes in labour market regulation that reduced employment protection (adopted in April 2013).

Labour market adjustment to the crisis is also impacted by labour market institutions. Among these, the importance of employment protection or different forms of flexibility is most frequently emphasised, alongside the active labour market policy measures, unemployment insurance and the wage-setting system. Slovenia responded to the aggravation of the labour market situation in 2009 and 2010 by reinforcing active labour market policies. In a period of crisis, active labour market policy can influence the demand for labour by programmes for job creation and employment incentives, while education and training programmes are important for developing new skills, which can reduce skills mismatches on the labour market and increase the employability of the unemployed. The implementation of an active labour market policy can thus have a positive impact on the recruitment of the unemployed. Labour market adjustment by means of wages started in Slovenia with a lag, the main reasons being the introduction of a new wage system in the public sector in 2008 and the increase in the minimum wage in 2010. In the period of the crisis the Slovenian labour market was also characterised by relatively strong employment protection, which was reduced only by changes in labour market regulation in April 2013. Since the reform, the labour market has undergone certain changes, which we evaluated by means of selected labour market indicators. However, for proper identification of the effects, a longer time period since adoption is needed (a longer time series), which would enable the use of econometric methods to extract other impacts on the labour market.

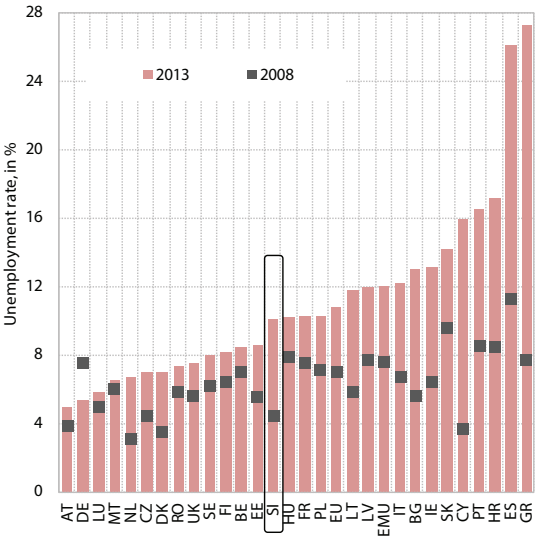
This section of Economic Issues shows developments on the labour market during the crisis and the response of labour market policies in the EU and Slovenia. The first chapter outlines the labour market trends in the EU and Slovenia. The second chapter provides an analysis of the labour market policy in Slovenia and an assessment of its direct contribution to lowering registered unemployment, while the third chapter analyses labour market developments in 2013, focusing on the effects of changes in labour market regulation on the flexibility and segmentation of the labour market. The section concludes by presenting the challenges that will have to be addressed by the government to improve the situation on the labour market.

1 Changes in the labour market situation in 2008–2013

1.1 Changes in the labour market situation in the EU

As a result of the economic crisis, the conditions on the labour market in the EU tightened notably after 2008. After the onset of the crisis in 2008, the first major labour market adjustment took place at the beginning of 2009. With economic activity declining, the majority of Member States adopted measures that temporarily alleviated the effects of the crisis on the labour market and eased the further worsening of the situation. In 2010, unemployment soared the most in the countries that were the 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). After easing in 2011, the labour market situation in the EU overall deteriorated again in 2012 and 2013 due to a decline or stagnation in economic activity. In the 2008–2013 period, as many of 6.5 million jobs were lost in the EU (in the euro area 5.3 million). In 2013 the unemployment rate in the EU averaged 10.8%, 3.8 percentage points more than in 2008. In 2013 it rose by 0.4 percentage points, but most of the increase took place in the first half of the year as the labour market situation eased slightly in the second half of the year. The differences in the unemployment rates of Member States continued to widen in 2013, reflecting different speeds of economic recovery in these countries and the different reactions of their labour markets to the crisis. The employment rate (20–64 age group) in the EU as a whole totalled 68.3% in 2013, which is 2.0 percentage points less than in 2008. Because of lower costs of adjustment, the number of persons in temporary employment declined more than the number of those on permanent contracts. The differences in the unemployment rates of Member States widened considerably in 2008–2013, particularly in the euro area, reflecting the different effects of the crisis on individual countries and the different mechanisms of labour market adjustment to lower economic activity (labour market resilience). The average number of actual hours worked per week in the entire period fell in the majority of EU countries (owing to schemes stimulating the shortening of working hours), which was reflected in a higher share of part-time employment in total employment.

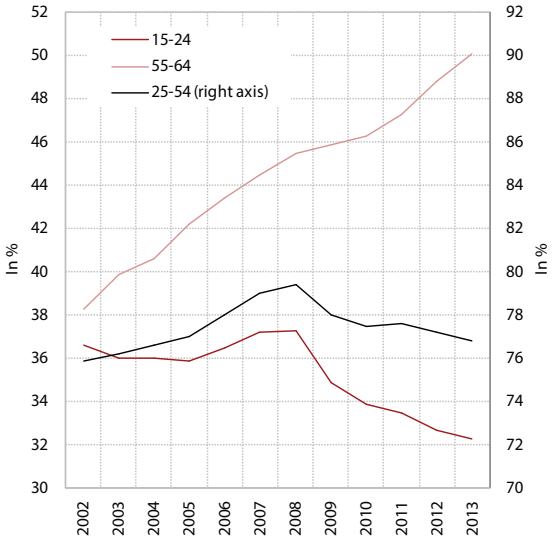
Figure 1: **Unemployment rates in the EU in 2008 and 2013**



Source: Eurostat.

Employment opportunities for men and young people worsened the most in 2008–2013. The employment rate of men decreased more than the employment rate of women, which was largely due to a substantial decline of activity in sectors that mainly employ men with lower education (e.g. construction). The entire period was marked by a decline in activity, which drastically reduced employment opportunities particularly for the young, with the youth unemployment rate (aged 15–24) rising and reaching 23.4% in the EU in 2013 (in the euro area 24.0%), 7.8 percentage points more than in 2008. In the majority of countries that were strongly affected by the sovereign and banking crises and in Croatia, the unemployment rate of the young more than doubled. In Greece and Spain, it exceeded 55.0%. The problem of youth employment is generally more pronounced among less educated youth, although the declining employment rate of young people who have at least an upper secondary education also reveals increasing problems in the transition from education to employment (European Commission, 2012). Unlike in other age groups, the employment rate of older people (aged 55–64) climbed by 4.6 percentage points to 50.1%. In the past three years alone, the employment rate of older people rose by 3.8 percentage points, mostly as a result of pension reforms. However, the differences between individual countries remain significant, in particular between the Scandinavian countries (Sweden, Denmark, Finland) and some Mediterranean countries (Greece, Croatia, Malta) and Slovenia, which has the lowest rate in the EU.

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



Source: Eurostat.

Long-term unemployment in the EU rose in 2008–2013, very long-term unemployment in particular.[1] Since the crisis began, the long-term unemployment rate has risen in all EU countries except Germany, particularly in the countries that were the most affected by the crisis. In 2013, 5.1% of the active population (6.0% in the euro area) were unemployed for more than 12 months, unemployment increasing most markedly among young people and people with lower levels of education. The long-term unemployment rate in the EU, which rose by 2.5 percentage points in the entire period, continued to grow in the second half of 2013, despite the easing of the labour market situation. In 2013 the long-term unemployed accounted for 47.5% of the total unemployed in the EU, 10.3 percentage points more than in 2008, of which 2.9 percentage points owing to the rise in 2013. The growing structural problems in a number of countries are also indicated by a rise in the very long-term unemployment rate, which continues to grow and has almost doubled in the EU overall.[2]

[1] The term very long-term unemployment refers to unemployment lasting more than two years.
[2] In 2013 it amounted to 2.9%, 1.4 percentage points more than in 2008.
[3] Labour hoarding was used particularly in service activities, where the costs of firing, and then hiring and training new workers are higher due to a higher level of firm-specific human capital.

1.2 Changes in labour market regulation in Slovenia in 2008–2013

As a result of the economic crisis, employment declined in Slovenia in 2008–2013, particularly in the private sector. Owing to the fall in economic activity in 2009 and the consequent labour market adjustment to lower economic activity in the following years, the number of persons in employment declined substantially in Slovenia. In 2013 their number (according to the statistical register) was approximately 85,000 persons or 9.7% lower than in 2008. The decline in employment was recorded only in private sector activities, where the number of employed persons in 2013 was 93,000 persons or 13.1% lower than in 2008. The relatively largest decrease in this period was seen in construction (by 38.3%) and manufacturing (by 20.1%), the sectors that also experienced the largest declines in activity. Other sectors recorded a slightly smaller decline in employment relative to the fall in activity, as companies in these sectors resorted to "labour hoarding"[3] during the crisis. In contrast, employment in public service activities increased, as it was not adjusted to the economic conditions for the most part of the 2008–2013 period. It started to decline slowly only in 2013, mainly due to fiscal consolidation measures, while it had risen by around 8,000 (5.0%) over the entire analysed period. This was also related to the measures for the containment of the wage bill in the general government being focused on the level of wages rather than on reducing employment.

Figure 3: **Economic growth and employment**

Source: SURS; calculations by IMAD.

Table 1: **Employment rates in Slovenia and the EU, by age group, in %**

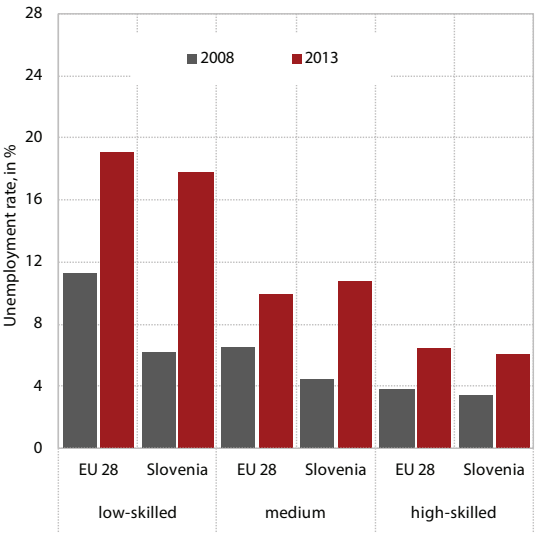
	Slovenia				EU			
	15-24	25-54	55-64	15-64	15-24	25-54	55-64	15-64
2008	38.4	86.8	32.8	68.6	37.3	79.4	45.5	65.7
2009	35.3	84.8	35.6	67.5	34.9	78	45.9	64.5
2010	34.1	83.7	35.0	66.2	33.9	77.5	46.3	64.0
2011	31.5	83.1	31.2	64.4	33.5	77.6	47.3	64.1
2012	27.3	83.3	32.9	64.1	32.7	77.2	48.8	64.1
2013	26.5	81.9	33.5	63.3	32.3	76.8	50.1	64.1

Source: Eurostat.

Employment in Slovenia declined more than in the EU overall, which can be explained by a larger fall in economic activity and structural weaknesses in the economy. In 2009–2011 the employment rate declined faster than on average in the EU. While the employment rate in the EU remained unchanged since 2011, the employment rate in Slovenia continued to fall. In the period from 2008, when it was the highest (68.6% in the 15–64 age group), considerably exceeding the EU average, it dropped to 63.3% by 2013, which is slightly less than the EU average (64.1%). Similarly, as in the EU, the contraction in employment was more severe for men than for women[4] due to a sharp fall in activity in the construction and manufacturing sectors. Likewise, the unemployment rate rose more in Slovenia than in the EU as a whole.[5] Greater deterioration in the labour market situation in Slovenia compared with the EU is related to the significant fall in economic activity due to structural weaknesses in the Slovenian economy.

The employment rate among low-skilled people dropped markedly in 2008–2013. The employment rate of low-skilled people, which stood at 42.9% in 2008, fell to 33.7% by 2013, largely due to the decline in activity in the sectors of manufacturing[6] and construction, which employ almost half of the low-skilled labour force. A similar drop was observed in the employment rate of people with an upper secondary education.[7] The employment rate of those with a higher education declined the least in this period, partly also due to a smaller fall in activity in sectors that employ a more educated workforce (public services, professional, scientific and technical activities) and are therefore more likely to hoard labour. The employment rate of people with a higher education fell from 87.5% to 82.4% in 2008–2013. As seen in Figure 4, the unemployment rate of high-skilled people rose much less than the unemployment rate of the low-skilled.

Figure 4: **Unemployment rates by level of educational attainment in Slovenia, in %**



Source: Eurostat.

As in the entire EU, 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 in Slovenia (the 15–24 age group) dropped by 11.9 percentage points in 2008–2013. The youth unemployment rate, in contrast, almost doubled and was twice as high as for adults. The share of jobless young people aged 15–24 years in the youth population rose from 4.5% in 2008 to 7.3% in 2013 (see Table 2). If economic activity declines, the labour market situation of young people usually deteriorates more than the situation of other age groups. In Slovenia the situation of young people deteriorated much more than in the EU overall. This can be attributed to the structural weaknesses of the

[4] Since 2008, when it totalled 72.7% (close to the EU average), the employment rate of men (15–64 age group) declined to 67.1% (below the EU average). The employment rate of women totalled 59.2% in 2013, which is 5 percentage points less than in 2008.

[5] In Slovenia, the unemployment rate totalled 10.1% in 2013, 5.7 percentage points more than in 2008, while in the EU as a whole it rose from 7.0% in 2008 to 10.8% in 2013.

[6] A significant decline in both activity and employment was recorded in low-technology industries.

[7] In 2008, it was above the EU average, at 72.0%, and then dropped below the EU average to 64.6% by 2013.

Table 2: **The share of unemployed young people (15–24 age group) and the NEET rates in Slovenia and the EU, in %**

	Share of young unemployed people aged 15–24 years		NEET rate	
	Slovenia	EU	Slovenia	EU
2008	4.5	6.9	6.5	10.9
2009	5.6	8.7	7.5	12.4
2010	5.8	9.0	7.1	12.8
2011	5.9	9.1	7.1	12.9
2012	7.1	9.7	9.3	13.1
2013	7.3	9.8	N/A	N/A

Source: Eurostat; calculations by IMAD.
Note: N/A - not available.

Slovenian labour market, such as a high prevalence of temporary employment contracts among the young population, which were not being extended during the crisis. The deterioration in job prospects for young people was also due to the low demand for labour in general, and a low number of job vacancies, where young people also have lower chances of finding a job due to a lack of work experience. The volume of student work, a significant factor in youth employment, also declined. It is, however, a very flexible and less secure type of work.[8]

The deterioration in labour market conditions for young people is also indicated by a higher share of those who are not in employment, education or training (the NEET rate). Apart from the share of unemployed young people, the share of those who are not in employment, education or training (the NEET rate) also rose in Slovenia in 2008–2013. Notwithstanding the high participation in education, the NEET rate of youth aged 15–24 years increased from 6.5% to 9.3% in 2008–2013.

The increase in unemployment among the young population was, alongside the crisis, also due to the mismatch between the fields of study chosen by young people and the fields of study demanded by the labour market. The structure of tertiary graduates according to their fields of education is unsuitable, as it does not meet labour market demand. This has, together with a significant increase in the number of graduates, contributed to the deterioration of the situation of young people on the labour market. With low demand and an increased number of Bologna programme graduates entering the labour market in the period 2008–2013, the unemployment rate of persons with a tertiary education almost doubled, totalling 6.1% in 2013. Entering the labour market in a time of high unemployment can also have a severe negative impact on the job prospects of young people after the recession. Young people who have been unemployed for a longer period are viewed negatively by prospective employers and are less likely to be hired even when the economy recovers, as they are regarded as less qualified because of their gap in employment. All these factors raise the probability and scope of a brain drain, which calls for effective implementation of the Youth Guarantee scheme intended to diminish the problems of young people seeking work. Furthermore, as the incentives for youth employment are governed by several different laws, it is also necessary to reconsider their level and form and monitor their effectiveness.

Table 3: **Unemployment rates in Slovenia and the EU, by age group, in %**

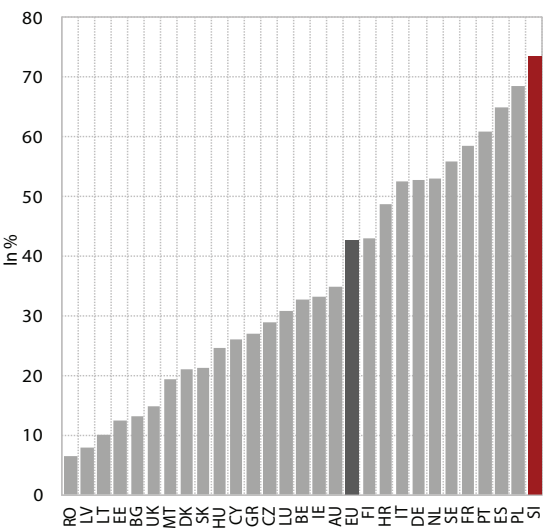
	Slovenia				EU			
	15-24	25-54	55-64	15-74	15-24	25-54	55-64	15-74
2008	10.4	3.7	4.0	4.4	15.6	6.1	5.1	7.0
2009	13.6	5.3	3.6	5.9	19.9	7.9	6.3	8.9
2010	14.7	7.0	4.0	7.3	21.0	8.6	6.9	9.6
2011	15.7	7.8	6.3	8.2	21.4	8.7	6.8	9.6
2012	20.6	8.3	6.2	8.9	22.9	9.5	7.3	10.5
2013	21.6	9.7	7.0	10.1	23.3	10.0	7.6	10.8

Source: Eurostat.

[8] In 2013 the volume of student work was 36.4% lower than in 2008.

Labour market segmentation by age has been a pressing problem in Slovenia for a number of years. In the majority of countries, young people tend to be more exposed to temporary employment than other population groups, but in Slovenia this is a particularly pressing problem. Slovenia has the highest share of young people (15–24 years) in temporary employment in the EU. In 2013 the share of temporary employment in the total employment of young people aged 15–24 stood at 73.2% in Slovenia, compared with 42.7% in the EU. This can be explained by the high prevalence of student work, which is attractive for employers due to simpler procedures and lower costs, as it allows faster adjustment to labour demand. Moreover, Slovenia also has a relatively high level of employment protection for permanent jobs compared with other countries as measured by the employment protection index developed by the OECD (for more on this, see Chapter 3.2). Student work represents a significant share of youth employment[9] and causes segmentation of the labour market, as it accounts for almost 80% of the temporary jobs of the young. Likewise, strong employment protection for permanent jobs, which was otherwise reduced in Slovenia in 2013, also tends to increase the use of temporary employment and the segmentation of the labour market (for more on this, see Chapter 3.1).

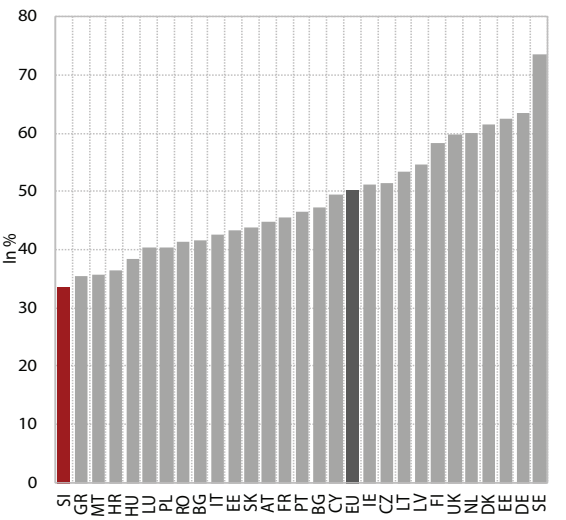
Figure 5: **The share of temporary employment in the total employment of young people (15–24 age group) in the EU, in %**



Source: Eurostat.

Slovenia has the lowest employment rate of older people, but it will increase in the years to come due to the pension reform that entered into force at the beginning of 2013. The employment rate in the age group of 55–64, which was 32.8% in 2008, climbed to 35.0% by 2010 as a consequence of the structural demographic effect and the pension reform of 2000 (particularly for women). In 2011 the employment rate of older people declined notably (to 31.2%), which could be related to the significant fall in the employment of older people at the end of 2010 due to the pension reform that was adopted in 2010 but later rejected at a referendum. In the last two years the employment rate rose again and thus exceeded the pre-crisis level in 2013 at 33.5% (see Table 1). In 2013, the first year of the implementation of the new pension reform, it rose by 0.6 percentage points, but was still the lowest in the EU. The pension reform that entered into force at the beginning of 2013 will, by extending the length of pensionable service by raising and equalising the retirement age for men and women, further increase the employment rate of older people in the coming years.

Figure 6: **Employment rates of older people (55–64) in the EU in 2013**



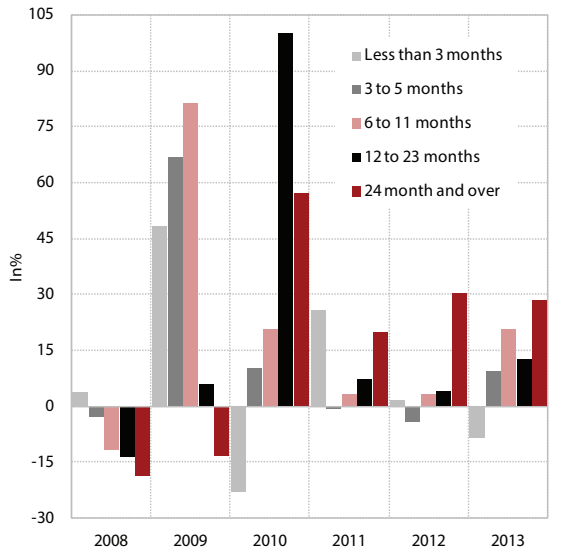
Source: Eurostat.

Structural unemployment has been rising ever since 2009, the long-term unemployed already accounting for more than half of all unemployed. As a result of low economic activity and, consequently, lower job prospects, an increasing share of the active population is remaining unemployed for longer and longer periods of time. The increase in long-term and very long-term unemployment is a sign of growing structural problems on the labour market. The long-term unemployment rate more than doubled in 2008–2013, amounting to 5.2% in 2013. The very long-term unemployment rate also more than doubled

[9] The share of youth employment through student agencies in total youth employment in 2013 totalled 46.2%.

in 2008–2013. Having been significantly lower than in the EU before the crisis, it reached 2.9% last year and nearly caught up with the EU average. The share of long-term unemployed people has been rising rapidly since 2009 and amounted to 51.0% in 2013 according to the labour force survey (20.9 percentage points more than in 2009). Particularly worrying is the relatively strong growth in very long-term unemployment (over 24 months) seen in the last two years, as it diminishes the possibilities for reducing unemployment in the next few years and increases the likelihood of the transition of unemployed people into inactivity. Dealing with the issue of long-term unemployment is therefore an important factor in improving the labour market situation.

Figure 7: **Growth in the number of the unemployed by duration of unemployment, Slovenia**



Source: Eurostat.

Wage growth in the private sector slowed during the crisis, but the adjustment to the crisis was less pronounced in wages than in employment (the impact of the minimum wage). The first response of the private sector to the crisis was to reduce the volume of overtime work and shorten working hours, followed by a significant reduction in employment, and in 2009 by a slowdown in wage growth, which was more pronounced and faster in industry than in market service activities. During the past few years, a considerable decrease was also seen in extraordinary payments, which reflect company performance.[10] 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 nevertheless mainly a result of the increase in the minimum wage[11] and changes in employment structure due to the layoffs of workers with relatively low wages.[12] Without the increase in the minimum wage and changes in employment structure, the growth of private sector wages in the 2009–2012 period would have been more than half lower, or around 1.5 percentage points lower, on average, per year.[13] Disregarding these two factors,

Table 4: **Growth in average gross wage per employee, 2006–2013**

Year	Nominal growth in gross wage per employee, in %				Real growth in 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
2013	-0.2	0.6	-1.3	-2.5	-2.0	-1.2	-3.0	-4.3

Source: SURS.

[10] In 2009–2013, wage growth in the private sector resulted only from the increase in basic wages, the contributions to growth arising from overtime and extraordinary payments being negative.

[11] According to our estimate, it contributed around 3 percentage points to the increase in the gross wage in private sector activities in 2010 (5.1%). In 2011–2012, the gradual increases in the minimum wage had only a minor impact (estimated at less than 1 percentage point) on the growth of the average wage in the private sector.

[12] This was a result of layoffs, particularly of workers with relatively low earnings, which was reflected in a statistical increase in the level of average earnings. According to our estimate, 9.9 percentage points of average earnings in private sector activities in 2009 were a consequence of this effect; in the following two years, this share was 0.5 and 0.2 percentage points, respectively.

[13] In 2009, 2011 and 2012, by approximately 0.9 percentage points lower; in 2010 by as much as 3.5 percentage points (the increase in the minimum wage).

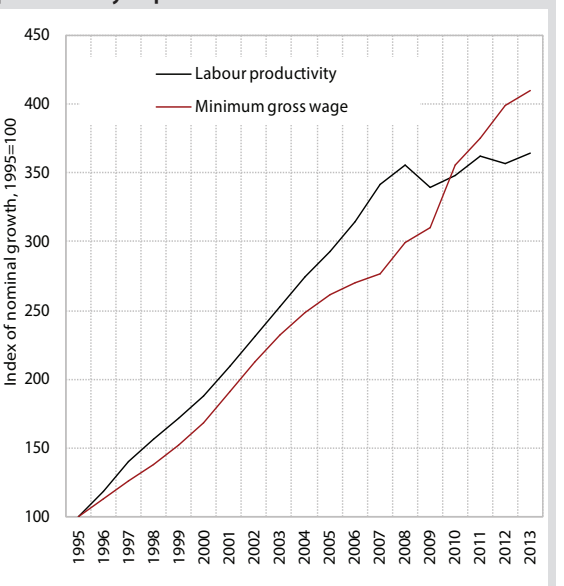
Box 1: **Minimum wage in Slovenia during the crisis**

According to the ratio of the minimum to the average gross wage, which in Slovenia rose significantly during the last two years, Slovenia ranks at the top of EU Member States. While in the 1996–2009 period the growth rates of the minimum and average gross wages were identical, the increase in the minimum wage in 2010 (the new Minimum Wage Act) and the crisis led to a considerable gap in their growth. The ratio of the former to the latter therefore increased from 41.2% in 2009 to 51.4% in 2013. A similarly high ratio was observed only in Greece (2011: 50.1%), while in other Member States it ranges between 31% and 48%. Following the latest legislative amendment to the minimum wage (in 2010), the share of minimum wage earners in the total number of employees also rose markedly (from 3.0% in 2009 to 8.6% in 2013). At the same time, in the whole period of the crisis, the gross minimum wage increased faster than labour productivity in private sector activities measured by value added per employee.

Figure 8: **Growth in minimum and average gross wages**

Source: SURS, Ministry of Labour, Family and Social Affairs; calculations by IMAD.

Figure 9: **Growth in minimum wage and labour productivity in private sector activities**



Source: SURS, Ministry of Labour, Family and Social Affairs; calculations by IMAD.

In addition to one of the greatest declines in economic activity in the EU during the crisis, Slovenia also recorded the largest increase in the minimum wage, which added significant pressure on the cost-competitiveness of the economy and job loss. In the period since the onset of the crisis, the minimum wage in certain EU Member States remained unchanged for several years (in Belgium, Bulgaria, Estonia, Lithuania, Latvia, Spain, Ireland and Portugal), while in seven Member States it even declined in individual years (in Croatia, the Czech Republic, Poland, Greece, Rumania, Hungary and the UK). In approximately one half of Member States the minimum wage fell in real terms during the crisis (2008–2013) amid the decline in economic activity. Slovenia recorded the largest real increase in the minimum wage in this period, 28.7%, which otherwise reduced wage inequality and the share of low-wage earners but also increased pressure on the cost competitiveness of the economy and job loss (for more on this, see Brezigar et al. (2010) and IMAD (2012)).

the responsiveness of the private sector's wage policy to the crisis was significant. It could have been even more pronounced had the system of wage formation been to a larger extent based on company-level agreements rather than sectoral collective agreements. While in 2012 and the first half of 2013 the gross wage in the private sector remained almost unchanged in nominal terms, as companies were trying to maintain a competitive position amid a renewed stagnation of economic activity, it has been strengthening since the middle of last year, especially in industry.

In the period since the beginning of the crisis, the movements of wages in the general government sector, the largest part of the public sector, were first impacted by the amended wage system and later mainly by the austerity measures of the government. The beginning of the crisis coincided with the beginning of the implementation of the long planned wage reform aimed at eliminating wage disparities among individual occupational groups in the sector, which resulted in a relatively high wage growth precisely during the period of crisis. In 2009 wage growth was already slightly lower, since during the year the first austerity measures were put in place,

partially restraining growth, before bringing it to a complete halt in 2010 and 2011. After even more severe austerity measures were passed due to the deteriorating fiscal situation, the average gross wage in the government sector dropped in 2012 and 2013 in nominal terms. The main factor in the 2.2% decline in 2012 was the fall in public servants' earnings in the middle of the year due to the adoption of the Fiscal Balance Act (ZUJF),[14] while the further decline in 2013 (-2.5%) was the result of the ZUJF being in effect for the entire year and the newly agreed measures from the middle of 2013.[15] In addition to the reduction in government sector wages, the past two years also recorded a slight moderation of wage growth in public corporations. Both employment and wages in the public sector started to be adjusted to the crisis situation later than in the private sector.

The austerity measures of the government sector wage policy during the crisis have mainly been focused on limiting the level of wages rather than employment, which has a demotivating effect on employees and makes it difficult to ensure high-quality services. A reduction in employment is, together with the level of wages, an important factor in determining the wage bill, which is also indicated by the movement thereof in the private sector. The decline in employment in the private sector during the crisis, together with slower wage growth, led to a decline in the wage bill, which was thus 3.6% lower in nominal terms in 2013 than in 2008. The wage bill in the general government sector was 8% higher in the same period, which was largely due to increased employment as the austerity measures mainly focused on the level of wages. The payment of regular performance bonuses was thus suspended as of April 2009, and the funds for an increased workload limited. Moreover, since 2011, civil servants have no longer been 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 than in lower wages. All these measures are decreasing the differences in earnings between employees and reduce motivation. At the same time, given the linearity of measures in the area of earnings, it is becoming difficult to ensure high-quality services.

[14] Wages of all public servants were cut by 8% in June, but at the same time public servants were paid the remaining two quarters of funds to eliminate disparities in wages. The net effect of both measures was a decline of around 3% in the gross wage per employee.

[15] The measures include a decline in basic wages (partly in a linear and partly in a progressive manner, by around 1.3% on average), the abolition of the increase in the seniority bonus paid to women for each completed year of service over 25 years and a reduction (by half) of the allowance for specialisations and master's and doctoral studies.

2 Labour market policy in Slovenia in the 2008–2013 period

Slovenia first responded to the deteriorating labour market conditions by adopting two intervention laws aimed at preserving jobs and stepping up active labour market policies (ALMPs), but over time its labour market policy became more passive. In 2009 two intervention laws were passed aimed at preserving jobs, which temporarily alleviated the drop in employment in Slovenia.[16] The greatest number of employed persons were included in the two schemes (the shortening of working hours and temporary layoffs) in the middle of 2009 (around 4.8% of the total active population) (for more see IMAD, 2011). Both schemes expired at the end of 2010. In 2009 and 2010 the number of persons participating in ALMPs increased and was 145% higher than in 2008. In 2011 and 2012 the number fell, before rising again in 2013.

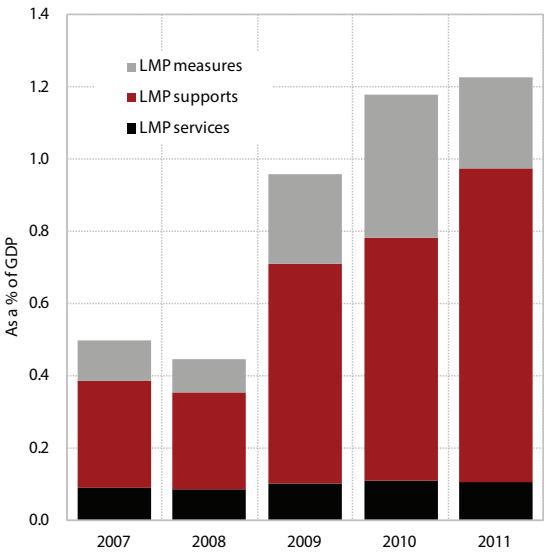
Slovenia supports the labour market policy, particularly active measures, with significantly lower financial resources than, on average, other EU countries. In 2011 (the most recent internationally comparable data), Slovenia's total expenditure on labour market policies accounted for 1.2% of GDP, while the EU, on average, spent approximately 50% more (1.9% of GDP). In the 2008–2011 period Slovenia's gap with the EU average narrowed due to a continuous increase in expenditure in Slovenia and a decline in the EU overall. In 2011 Slovenia had a wider gap with the EU average in expenditure on active LMP measures[17] than in expenditure on LMP supports.[18] Even though it increased expenditure on active measures in 2008–2011, Slovenia remains in the lower third of countries with regard to the allocation of funds for this type of intervention. Looking at the structure of expenditure on active measures, Slovenia lags most notably behind the EU in the share spent on education and training, while it exceeds the EU average in expenditure on direct job creation and start-up incentives, which is not appropriate from the aspect of the needed increase in the employability of the long-term unemployed.

[16] In January 2009, Slovenia adopted the Partial Subsidising of Full-time Work Act. At the end of May 2009, the parliament also adopted the Partial Reimbursement of Payment Compensation Act, which regulates the partial reimbursement of wage compensation for employees "on temporary layoff«.

[17] In 2011 Slovenia allocated 0.25% of GDP for active measures, the EU average being 0.49% of GDP.

[18] In 2011 Slovenia allocated 0.87% of GDP for LMP supports, the EU average being 1.2% of GDP.

Figure 10: **Total expenditure on labour market policies* in Slovenia, as a % of GDP**



Source: Eurostat.
Note: *According to Eurostat's definition, labour market policy measures comprise: (i) **labour market policy services** covering all services and activities of the public employment services together with any other publicly financed services for jobseekers; (ii) **active labour market policy measures** covering interventions which provide temporary support for groups that are disadvantaged on the labour market and which aim at activating the unemployed (training, job rotation and job sharing programmes, employment incentives, supported employment and rehabilitation, direct job creation and start-up incentives); (iii) **labour market policy supports** which involve financial assistance that aims to compensate individuals for loss of wage or salary and support them during job-search or accelerate an early retirement (out-of-work income maintenance and support and early retirement).

After declining in 2011 and 2012, the number of persons involved in active labour market policy measures rose in 2013. In 2009 and 2010, the number of participants in active labour market policy (ALMP) measures more than doubled relative to 2008. Although the structural problems on the labour market increased in 2011 and 2012, the number of the unemployed included in ALMP programmes declined markedly. This is also reflected in a decline in their share in total employment, which in 2013 rose again (see Table 5). Despite the increase, the share of the unemployed participating in education and training programmes was relatively low (lower than before the crisis), which is, however, not appropriate from the aspect of structural imbalances and the necessary increase in the employability of the unemployed in the period of gradual economic recovery. In particular, shorter education and training programmes (such as on-the-job training) are regarded as some of the most effective interventions on the labour market (Martin and Grubb (2001)).

In 2013 the shares of older and low-skilled participants increased the most, which may be favourable in terms of eliminating structural problems. To analyse the scope and targets of ALMP programmes, we calculated the ratio of the number of unemployed persons from a given group who participate in ALMPs to the total number of the unemployed in this group and labelled this the participation rate. It serves as an approximate indicator of the participation of the respective group. In 2013 the participation rates of people older than 50 and low-skilled people, i.e. those who find it very difficult to find a new job if they become unemployed, increased the most. This is otherwise favourable from the perspective of eliminating structural imbalances and improving employment prospects for these unemployed persons, but the participation rates of older people and low-skilled people are still relatively low, regardless of the increase. Given the increasing difficulties of young people on the labour market, it is favourable that the participation rates of young people and first-time jobseekers also rose in 2013.

The impact of active LMP measures on unemployment increased in the 2008–2013 period. The higher participation of the unemployed in ALMP programmes that involve direct job creation was also reflected in a higher share of "supported employment" in the total outflow from unemployment, which is used to assess the impact of ALMPs on the movement of registered unemployment. In 2008–2013 the share of supported employment almost doubled, reaching 14.6 % in 2013. It rose most notably in the 15–29 age group, which indicates that labour market policy responded appropriately to the deteriorating employment opportunities for youth during the

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

	2007	2008	2009	2010	2011	2012	2013
Training and education	19.4	20.5	24.9	28.7	15.6	11.2	15.7
Employment incentives	0.6	1.6	5.2	4.3	2.5	1.7	4.1
Job creation	5.0	7.2	5.6	6.7	2.8	6.0	4.9
Promotion of self-employment	0.6	7.7	12.6	19.4	14.2	7.5	9.3
Total	25.7	37.1	48.3	59.2	35.0	26.5	33.9
Lifelong career orientation	8.2	8.9	11.4	11.8	9.2	8.2	14.3

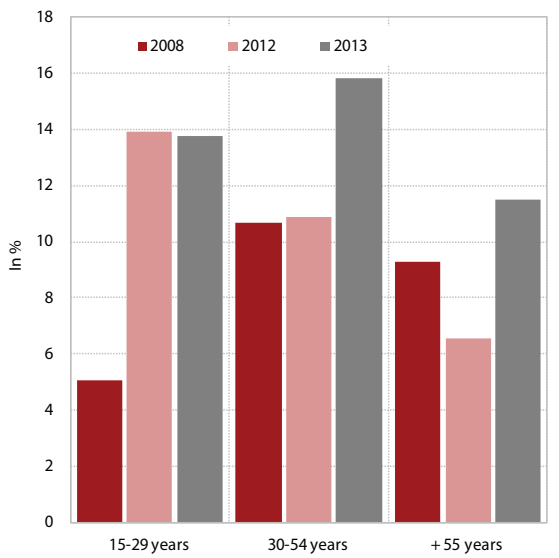
Source: ESS; calculations by IMAD.
Note: * The participation rate is the ratio of the number of the unemployed included in ALMPs to the average number of the unemployed.

Table 6: **Participation rate of the unemployed in ALMP programmes, in %**

	2007	2008	2009	2010	2011	2012	2013
Unemployed persons (UP), total	25.7	37.1	48.3	59.2	35.0	26.5	33.9
UP aged over 50 years	10.2	17.4	20.2	22.3	13.9	13.6	18.0
UP for one or more years	29.7	30.7	29.4	40.7	21.9	19.6	22.0
UP aged below 25 years	34.1	38.1	50.7	65.3	43.0	26.7	29.4
UP low-skilled	21.3	22.0	30.3	35.6	20.9	15.4	19.6
UP recipients of social benefits in cash	7.2	14.4	25.4	29.3	21.3	14.9	16.7

Source: ESS; calculations by IMAD.

Figure 11: **The share of "supported employment" in the outflow from unemployment by age group**



Source: ESS; calculations by IMAD.

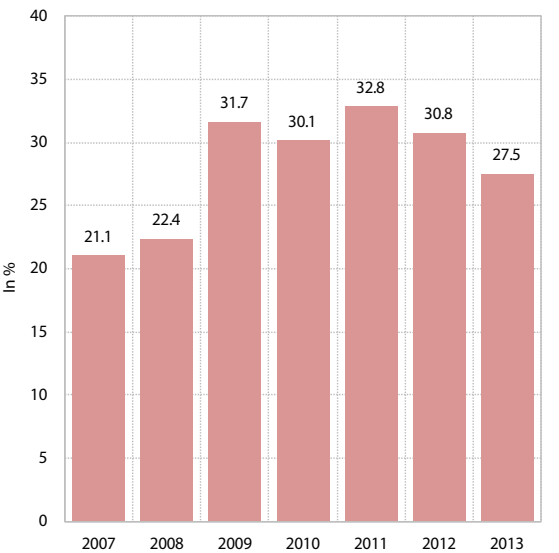
crisis.[19] However, as is evident from Figure 11, in 2013 the share of supported employment increased the most in older age groups.

The income security of the unemployed, another important factor of the flexicurity concept, should be provided by labour market supports (unemployment benefits). Slovenia is ranked low in terms of the unemployment benefit coverage rate (the share of unemployed persons receiving unemployment benefits in the total number of the registered unemployed), which indicates problems with regard to the accessibility of unemployment benefits. At the same time, the system of unemployment benefits for low-skilled people in Slovenia gives the unemployed little incentive to search for jobs in the initial phase of unemployment (the so-called high unemployment trap). Establishing a system of unemployment insurance that ensures the income security of the unemployed, while at the same time preserving appropriate incentives to work, therefore presents another challenge.

[19] The share of "supported employment" in the total outflow in the 15–29 age group in 2013 was 13.8%, 8.7 percentage points more than in 2008.

After increasing in 2008–2011, the share of unemployment benefit recipients among all unemployed fell in the last two years. In 2013 the average number of the registered unemployed in Slovenia was 68% higher than in 2008, while the number of recipients of unemployment benefits was 119.2% higher than in 2008. The movement of the number of unemployment benefit recipients was significantly impacted by the structure of the inflow to and outflow from unemployment and the increase in the number of long-term unemployed persons who are no longer entitled to unemployment benefits. The decline in the share of unemployment benefit recipients in the total number of the unemployed in 2012 and 2013 was due to a higher inflow of first-time jobseekers, who are not yet eligible for unemployment benefits, and a higher outflow of older unemployed persons. In the 2008–2011 period the share of expenditure on passive interventions in total LMP expenditure increased (see Figure 10), while in 2012 and 2013, expenditure on unemployment benefits declined.

Figure 12: **The share of recipients of cash benefits in instances of unemployment among the registered unemployed**



Source: ESS; calculations by IMAD.

3 Changes in labour market regulation in 2013 and their effects

Within the reform of labour market regulation in 2013, a number of amendments were passed with a view to reducing segmentation and increasing flexibility. In April 2013 the new Employment Relationship Act (ZDR-1) and the Act Amending the Labour Market Regulation Act (ZUTD-A) entered into force as the legal foundation for the labour market reform, the main goals of the changes being the following: (i) reducing labour market segmentation; (ii) increasing flexibility; and (iii) increasing the legal protection of employees. This chapter analyses labour market trends in the period after the adoption of the changes (April 2013–March 2014) from the aspect of the effect of changes in labour market regulation on segmentation and flexibility.

Some amendments to labour market legislation in 2013 were focused on reducing segmentation with regard to the type of employment contract and segmentation by age. The ZDR-1 simplifies the termination procedure for permanent employment contracts, reduces the costs of the dismissal of workers in permanent employment (notice periods and severance payments) and applies some new restrictions to the conclusion of fixed-term contracts. In addition to the amendments to the ZDR-1, in 2013 the following amendments were made to other laws in order to lower labour market segmentation: (i) exemption, for two years, from the payment of contributions for unemployment insurance for employees hired on permanent contracts and an increase in the contributions for unemployment insurance for persons hired on fixed-term employment contracts; (ii) exemption from the payment of part of employers' contributions for pension and disability insurance for older workers and a refund of employers' contributions for employees in first permanent employment. With a view to reducing labour costs for individual categories of employees, the ZPIZ-2 provides the possibility for employers to exercise an exemption from the payment of part of the contributions, or claim a refund of the contributions, for the first year after hiring older[20] or young[21] employees; (iii) exemption, for two years, from the payment of employers' social security contributions for signing a permanent employment contract with a person under the age of 30 who has previously been unemployed for three months.[22]

In order to increase labour market flexibility, Slovenia made some changes towards reducing employment protection. In addition to lowering severance payments, shortening notice periods and simplifying termination procedures for permanent employment contracts, which may also work towards lower segmentation, the following changes were introduced: (i) the possibility of assigning the employee other work;[23] (ii) the institute of temporary layoff;[24] (iii) the possibility of time-limited and occasional work for pensioners; (iv) the inclusion of workers in appropriate active labour market policy measures already during the notice period;[25] (v) compensation in cash instead of reintegration.[26]

[20] In accordance with Article 156 of the ZPIZ-2, employers are exempt from the payment of part of the contributions for older employees who fulfil the age conditions for acquisition of the right to early retirement under Article 29, Paragraph 2 of the ZPIZ-2 (employers are exempt from the payment of 50% of employers' contributions for these employees) and those who turn 60 (employers are exempt from the payment of 30% of employers' contributions for these employees).

[21] In accordance with Article 157 of the ZPIZ-2, employers may request a refund (for the first year of employment in the amount of 50% and for the second year in the amount of 30% of the contributions of employers) for insured persons under the age of 26 and mothers who take care of children under the age of 3 if this is their first permanent employment and they remain with the same employer in an employment relationship without interruption for at least two years.

[22] Under the Act on Intervention Measures in the Field of the Labour Market and Parental Protection, employers who in the period between 1 November 2013 and 31 December 2014 sign a permanent employment contract with an unemployed person under the age of 30 who has been registered as unemployed for at least three months prior to signing the permanent employment contract are exempt from the payment of employers' contributions for pension and disability insurance, health insurance, parental protection insurance and unemployment insurance for the first 24 months after hiring this person.

[23] The ZDR-1 (Article 33) introduced the possibility that during an employment relationship the employer may order the worker to carry out other work, unless otherwise provided in an act or collective agreement.

[24] The ZDR-1 (Article 138) introduced the institute of a "temporary layoff". In the event of a temporary layoff, the worker is entitled to 80% wage compensation. The employer may, by written notice, temporarily lay off the worker for a period that may not exceed six months in one calendar year.

[25] Under Article 97 of the ZDR-1, the employer must enable the worker to be absent from work for at least one day per week to integrate into activities on the labour market in accordance with labour market regulations. For the time of such absence, the employer is obliged to pay the worker 70% wage compensation, which is reimbursed by the Employment Service (Article 13 of the ZUTD-A).

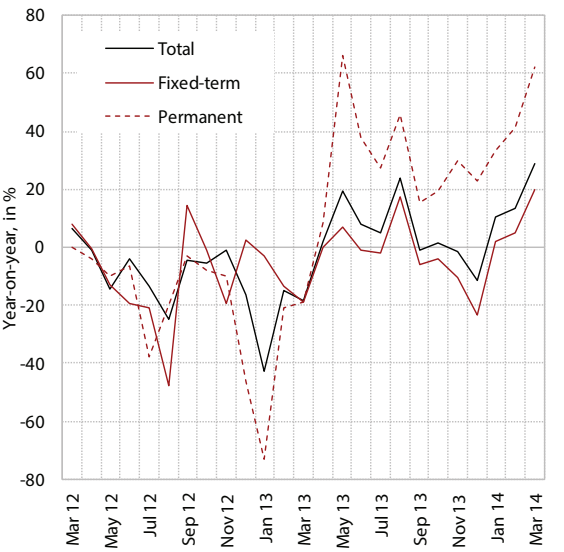
[26] Article 118 of the ZDR-1 stipulates that where a labour court has established that the termination of an employment contract is illegal but that, with regard to the circumstances and the interests of both contracting parties, the continuation of the employment relationship would no longer be possible, the court, upon a proposal made by the worker or employer, may grant the worker adequate compensation instead of reintegration (return to work).

An analysis of changes in labour market regulation based on selected indicators of labour market trends did show certain effects, but given the relatively short period since the reform was passed, it is difficult to determine to what extent they can be attributed exclusively to changes in labour market regulation. Because of the short time period since the adoption of the reform, the evaluation of its effects is based on selected indicators of labour market trends. We also tried to assess the effects by means of the labour demand function and model simulation. In addition to the short time series, the effects are also difficult to assess due to the changes in economic activity. For example, as the effects of changes in employment protection depend on the economic situation, reforms towards a more flexible labour market generally have a greater impact in favourable economic conditions. When more flexible legislation allows companies to more easily adjust to various economic conditions, the reforms will – in favourable economic conditions – positively contribute to the decline in unemployment as companies can employ workers more rapidly and easily. However, in unfavourable economic conditions, the introduction of such reforms can lead to increased transition from employment into unemployment (Bouis et al., 2012). Moreover, certain measures adopted to reduce segmentation also lower flexibility. The two objectives are thus in conflict and cannot be achieved simultaneously. Changes in flexibility, in particular, will thus have a greater effect in favourable economic conditions when labour demand improves.

3.1 Effects of the changes in labour market regulation on labour market segmentation

Labour market segmentation has been a pressing problem in Slovenia for a number of years. It manifests itself particularly in the high share of fixed-term jobs among youth, the highest in the EU. In the initial period after the beginning of the crisis, the share of people on permanent employment contracts in the total number of people in formal employment increased, as employers first responded to lower economic activity by not extending fixed-term contracts. The share of permanent jobs started to fall only towards the end of 2009 when, amid a further decline in economic activity, companies had to start restructuring and more frequently opted for fixed-term hiring due to increased uncertainty. Amid a relatively high level of permanent employment protection, the share of fixed-term jobs started to increase gradually, also as fixed-term contracts represented a more flexible form of employment for employers. This type of employment was used to employ first-time jobseekers in particular, who are mostly young. The labour market has thus become more and more segmented: on one hand, there are employees in more secure permanent employment, whose share is otherwise declining, while on the other hand, there is a rising share of those in more flexible forms of employment, which are cheaper for employers and provide less security for employees. The majority of first-time or new jobseekers have thus been exposed to flexible forms of employment. The labour market has also become segmented by age, not just by type of employment. The employment rate of older people (55–64 years) is very low, the lowest in the EU, in addition to the effects of early retirement in the past also due to lower employment opportunities and barriers to employment for older people. On the other hand, the employment prospects of young people also deteriorated significantly during the crisis.

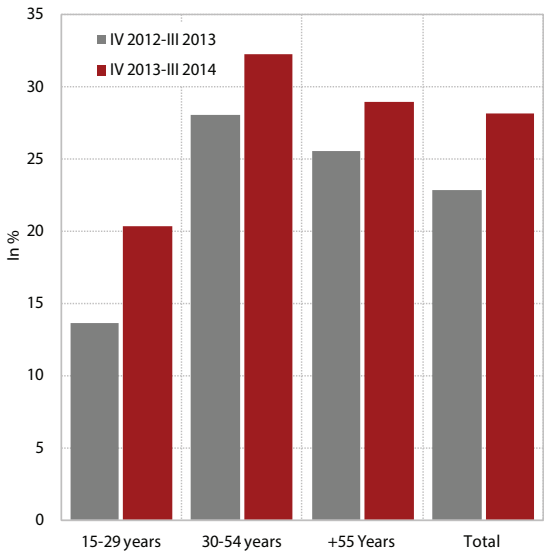
Figure 13: **Year-on-year growth in new jobs by type of employment contract, in %**



Source: SURS, SRE; calculations by IMAD.

Since the adoption of the reform, permanent employment has been rising more rapidly than fixed-term employment. This is indicated by data in the Statistical Register of Employment (SRE) on new jobs by type of contract (fixed-term/permanent) (see Figure 13). Faster growth in permanent jobs characterised the entire period since the legislative changes were adopted (April 2013 to March 2014); the number of new permanent jobs among young people (15–29 years) was higher, while the number of fixed-term jobs was lower in year-on-year terms. If such movements continue, labour market segmentation by age may gradually decline.

Figure 14: **The share of permanent jobs in new jobs, in %**



Source: SURS, SRE; calculations by IMAD.

The share of permanent jobs in the total number of new jobs has increased since the adoption of the changes, which indicates a move towards lower labour market segmentation. The share of new permanent jobs in the period from April 2013 to March 2014 (i.e. after the reform) was higher than in the period from April 2012 to March 2013, particularly in younger age groups. Nevertheless, in all age groups, the majority of new jobs were fixed-term also after the adoption of the reform (71.8% of all new jobs; 77.1% in the same period of 2012).

After the legislative amendments entered into force, the share of people in a standard employment relationship declined, while the share of those in other forms of employment increased. People in regular employment[27] represented 82.6% of total employment in 2013, 0.4 percentage points less than in 2012. Data from the Labour Force Survey (LFS) show that in the first year after the reform was passed (April 2013–March 2014), their share was 1.2 percentage points lower than before the reform. On the other hand, the shares of self-employed people and people in other forms of employment in total employment increased, according to the LFS. This could mean that employers partly replaced regular employment contracts by other forms of work (in particular, by engaging self-employed workers[28] and, partly, by other types of employment). The latter may be, in an environment of modest economic activity, a result of legislative changes regarding fixed-term employment, although it could also be due to different self-employment incentives.

Last year' changes in labour market regulation did not interfere with the system of student work, a major factor in the strong labour market segmentation in Slovenia. Student work accounts for a significant share of total employment and has a substantial impact on segmentation by age: in 2013, it represented almost 80% of temporary jobs of the young (15–24 years), where Slovenia has the highest share in the EU (see Figure 5). In terms of the share of fixed-term employment contracts in total employment contracts (47.4% in 2013), Slovenia is only slightly above the EU average (42.7%). Reforming the regulation of student work, which is also necessary in order to reduce segmentation, therefore remains a challenge. In this respect, it is, however, necessary to consider that student work accounts for a substantial share of youth employment and that serious restrictions in this area could significantly exacerbate the situation of young people on the labour market and, at the same time, limit the flexibility of employers. As an analysis of student work (Šušteršič et al., 2010) showed that students mainly perform physical and other less demanding types of work. Student work should be more closely tied to gaining experience, which would have a positive effect on the future career development of students/pupils and facilitate their transition from education to employment. In formulating changes in labour market regulations, it is, however, first necessary to define the goals and methods for their realisation.

3.2 The effects of the changes in labour market regulation on flexibility

The changes aimed at increasing flexibility on the labour market involved reducing employment protection. Labour market flexibility, which can be defined as a set of factors that make it possible for employers to adjust to changing demand, has become one of the major obstacles to the competitiveness of the economy during the crisis, which was also reflected in a deterioration of Slovenia's position on international competitiveness scales in this area.[29] On one hand, this can indicate that Slovenia started to take measures to increase flexibility later

[27] The share of employees with permanent or fixed-term employment contracts.

[28] In the year after the adoption of the changes, the share of self-employed people was 0.8 percentage points higher than in the preceding year.

[29] In 2008–2013, Slovenia slipped 13 places in the labour market flexibility rankings according to the World Economic Forum (WEF) and 15 places in labour market efficiency on the global competitiveness scale of the International Institute for Management Development (IMD).

than other countries. However, Slovenia's status as regards labour market efficiency and flexibility is not measured only by indicators that were changed last year.[30] The low ranking in the labour market area relative to other countries is therefore still mainly attributable to the lack of tax incentives to work and the high level of labour taxation. The employment protection legislation (EPL) index of the OECD also showed that labour legislation in Slovenia was fairly rigid in comparison with other countries before the 2013 reform.

The Employment Relationships Act (ZDR-1) brought about changes that lowered the employment protection legislation (EPL) index. It simplified the dismissal notification procedures, which had been estimated as very rigid before the reform.[31] It also changed the length of notice periods, which even before the implementation of the reform had not exceeded the OECD average. The maximum notice period was reduced from 120 to 60 or 80 days.[32] The new act (ZDR-1) also slightly reduced severance payments. All these changes lowered the EPL index and established the conditions for greater labour market flexibility and made employers less cautious with regard to hiring. However, at the same time, severance payments for fixed-term employment were introduced, which is a measure that could have the opposite effect.

In 2013 the OECD revised the method for calculating the EPL index, so that a summary index no longer exists. Until 2013 the OECD published the total EPL index, which incorporated three sub-indices: (i) the protection of permanent workers against individual dismissal; (ii) the regulation of temporary forms of employment; and (ii) specific requirements for collective dismissal. In 2013 the methodology was changed. The OECD still evaluates the same items of labour market legislation by the same method, but the results are no longer summarised in one index but in four, as shown in Table 7. In last year's Economic Issues, we published our estimate of the employment protection legislation index prepared according to the previous methodology – which also indicated a decline in employment protection in Slovenia[33] (IMAD, 2013) – and used it in the econometric analysis of labour demand (Box 2). The following paragraphs present new OECD estimates according to the new methodology before and after the change in regulation.

If measured by the employment legislation protection index, the most notable change was made in the area of the protection of regular workers against individual dismissal. According to OECD estimates, seven of the twenty-two items on the EPL index were evaluated as less restrictive (a decline in value) and two as more restrictive (an increase in value) after the legislative changes in 2013. This was reflected in a decline in the sub-indices of employment protection for regular workers against individual dismissal (EPR) and the regulation of temporary contracts (EPT). Following the changes in 2013, the regulation of protection against individual dismissal became more flexible than, on average, in the OECD (see Figure 15), while the regulation of temporary employment is still slightly more restrictive than in the OECD. The legislation regarding additional provisions for collective dismissals did not change with the ZDR-1.

Table 7: **EPL indices in Slovenia before and after the reform in 2013**

	Protection of regular workers against individual and collective dismissals (EPRC)	Protection of regular workers against individual dismissal (EPR)	Additional restrictions for collective dismissals (EPC)	Regulation of temporary forms of employment (EPT)
Slovenia – 2013 (before the reform)	2.67	2.39	3.38	2.50
Slovenia – May 2013 (after the reform)	2.39	1.99	3.38	2.13
Non-weighted OECD average	2.29	2.04	2.91	2.08

Source: OECD 2014.

[30] For example, last year's changes in regulation were thus reflected only in three of seven components of labour market efficiency according to the WEF (for one, the figures from 2012 were taken into account).
[31] The ZDR-1 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 the event 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 the termination of an employment contract based on the negative opinion of the workers' representatives is now limited to these workers only, while previously it had applied to all. Likewise, there has been a reduction regarding the delay before a notice can take effect.
[32] The notice period is 80 days only for workers with more than 25 years of service, the maximum notice period for all other workers being 60 days.
[33] The total employment protection index declined from 2.76 to 2.19 after the adoption of changes, according to the IMAD estimate.

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, 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.

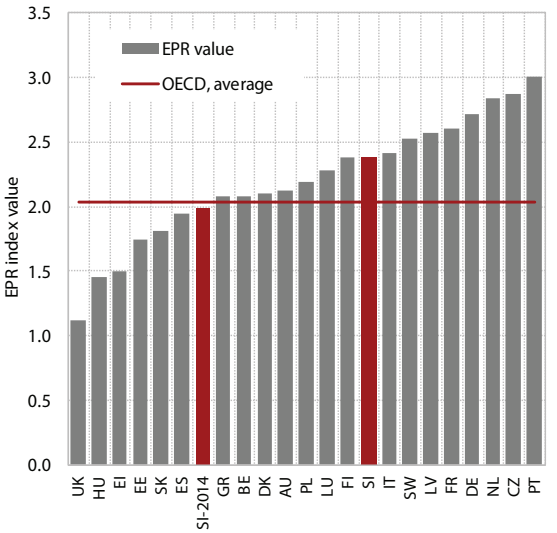
Table 8 presents the estimated dynamic functions of labour demand for the entire economy in the period 1995-2011. Given the verification of the robustness of results, the function is assessed by two different reform indices. For the evaluation of reform measures in the second column, the total EPL index is used; in the third column, only its most important component is used, i.e. regular employment.

Table 8: **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 and 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.

Figure 15: **The values of the index of protection of regular workers against individual dismissal (EPR) in OECD countries that are also EU Member States**



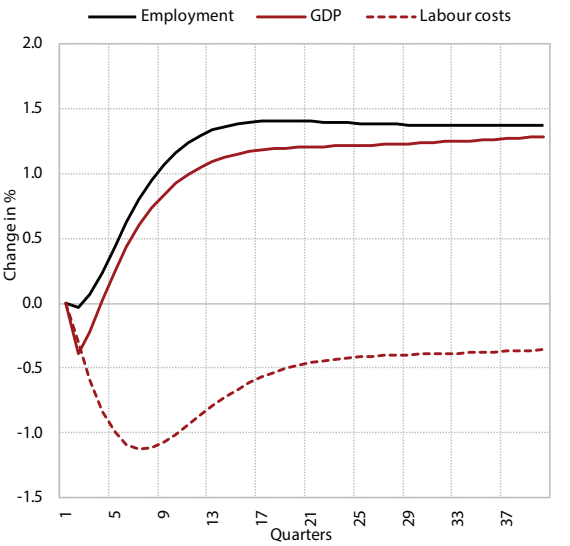
Source: OECD.
Note: SI-2014 denotes the index value for Slovenia after the adoption of the changes.

The econometric assessments of the labour demand function indicate that the adopted reform could have a positive, albeit modest, impact on employment and increase elasticity of employment with regard to labour costs. We assessed the impact of the changes in labour market regulation – as measured by the EPL index – on employment and labour flexibility in Slovenia by the dynamic function of labour demand evaluated on the basis of the data of Slovenian companies. The effects of the changes on employment were analysed by means of the total EPL index and its most important sub-index, the protection of regular employment, according to the previous methodology, and by IMAD's evaluation of the total EPL index.[34] Both models yielded very similar results (see Box 2). The reduction in employment protection may have positive, albeit modest, effects on employment. At the same time, the changes could make it easier to adjust employment to changing labour costs and hence contribute to increased hiring when the economy rebounds. In such conditions, the effect of greater labour market flexibility due to less strict employment protection will also be more visible.

A model simulation using a DSGE model also shows possible positive effects on employment. The response of economic activity and employment to greater employment elasticity with respect to labour costs was simulated by a DSGE model. Figure 16 shows the responses of GDP and employment to increased employment elasticity with regard to labour costs,

[34] According to the IMAD estimate, the total EPL index declined from 2.76 to 1.99 with the regulatory changes.

Figure 16: **Impulse responses of employment and GDP to changes in employment elasticity with regard to labour costs.**

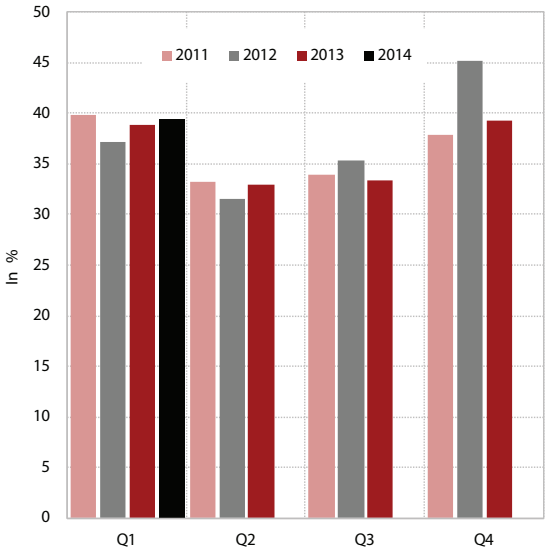


Source: DSGE model; calculations by IMAD.

which is to reduce labour costs by an average of 1% in the first eight quarters. Such a positive shock in employment elasticity with respect to labour costs increases employment and GDP by 1.4% and 1.3%, respectively, in the long term.

As a general rule, a reduction in employment protection increases mobility on the labour market, which is one of the indicators of flexibility. Empirical studies of the impact of employment protection on the labour market situation indicate that less rigid protection intensifies the flows out and into unemployment and decreases the unemployment of vulnerable groups, long-term unemployment and labour market segmentation. However, the effects of reforms towards lower employment protection depend on the economic situation (Bouis et al., 2012). When more flexible legislation allows companies to more easily adjust to various economic conditions, the reforms will – in favourable economic conditions – have a positive impact on the decline in unemployment, as companies can employ workers more rapidly and easily. On the contrary, in unfavourable economic conditions, the introduction of such changes in employment protection can lead to increased transition from employment into unemployment. In our analysis, we measured mobility by the reallocation rates of unemployed and employed people, which indicate labour market dynamics and hence, indirectly, the degree of flexibility. The reallocation rate of the unemployed is calculated as a ratio of the sum of the inflow to unemployment and the outflow from unemployment into employment to the average number of unemployed persons in a given quarter. The reallocation rate of employed

Figure 17: **Reallocation rate of the unemployed**



Source: SRE; calculations by IMAD.

persons is calculated as a ratio of the sum of the inflow into employment and the outflow from employment[35] to the average number of all employed persons in a given quarter.

The reallocation rate of the unemployed increased slightly after the adoption of the changes. The reallocation rate of unemployed persons in 2013 was lower than in the second half of 2012, which can be explained by the significant inflow of older people related to the adoption of the ZPZI-2. The reallocation rate of the unemployed for the second half of 2012 therefore does not show the real picture of labour market dynamics, in our assessment. However, a comparison of the period after the adoption of the changes (April 2013–March 2014) and the period from the second quarter of 2011 to the second quarter of 2012 (q2–2011 to q2–2012) shows a 0.7 percentage points higher rate in the period after the reform. That the reallocation rate of the unemployed increases is also indicated by the reallocation rates for the first quarters in 2012–2014.

In contrast, there was no significant change in the reallocation rate of employed persons, which can mainly be explained by a smaller outflow from employment due to a gradual recovery in economic activity. The measurement of labour market flexibility and dynamics using the reallocation rate of employed persons, which is calculated as a ratio of the sum of newly employed persons and those who lost jobs to the total number of employed persons, shows almost the same reallocation rate in the first quarter of 2014 as in the first quarter of 2013; however, in year-on-year terms, the number of newly employed persons is much larger, while the outflow from employment is much smaller, which can be attributed to the gradual recovery of economic activity.

After the reform in labour market regulation, job creation increased compared with the same period last year. In the period after the enforcement of the reform (between April 2013 and March 2014), 5.6% more new employment contracts were concluded than in the same period before the reform. This can be attributed to a slight increase in economic activity towards the end of 2013, but was also a result of changes in labour market regulation. As is evident

Table 9: **Newly concluded contracts by age group**

	Number	Number	Change, %
	period IV 12-III 13	period IV 13 - III 14	
Total			
15-29 years	46,855	46,902	0.1
30-54 years	79,203	88,675	12.0
55 +	6,378	7,005	9.8
Total	132,436	142,582	7.7
Fixed-term			
15-29 years	40,464	37,371	-7.6
30-54 years	56,935	60,062	5.5
55+	4,745	4,974	4.8
Total	102,144	102,407	0.3
Permanent			
15-29 years	6,391	9,531	49.1
30-54 years	22,268	28,613	28.5
55 +	1,633	2,031	24.4
Total	30,292	40,175	32.6

Source: SURS, SRE; calculations by IMAD.

[35] As a result of administrative changes in the Employment Register, only data for the first quarter of 2014 are comparable in year-on-year terms.

from Table 9, the number of fixed-term employment contracts signed in this period was similar to that in the year before the reform, while the number of permanent employment contracts increased. The latter may indicate that employers were more willing to hire employees on permanent contracts due to the lower protection of permanent employment and the slightly more flexible labour legislation, which also worked towards lowering segmentation. Table 9 shows a lower number of new jobs than before the reform in the 15–29 age group, which is mainly due to fewer young people being hired on fixed-term contracts as employers may have partly replaced them by engaging self-employed people instead.

Last year's changes extended the legal basis for the inclusion of redundant workers in LMP services and measures already during the notice period. 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 already during the notice period. The employer is obliged to pay wage compensation for the time of the worker's absence from work but the indirect payer is in fact the worker, as the employer can claim a refund: when the worker registers as unemployed, the duration of receiving unemployment benefits is shortened by the time of such absence, i.e. by the number of days for which the employer claimed the refund. In the period from April to the end of December 2013, 211 workers were included in the reimbursement-of-wage-compensation scheme due to searching for work during the notice period, while only five workers in that scheme were included in ALMP programmes (Poročilo DS, 2013). This means that the incentives for the faster re-entry of dismissed workers into the workforce, i.e. already during the notice period, did not work in practice. In our estimation, the main reasons are the peculiarity of the solution (the indirect payer being the worker), a lack of human resources for its implementation, and the complicated administrative procedure.

By reducing employment protection, the reform created conditions for greater flexibility, but the effects thereof can only be seen in the long term. In assessing the effects of changes on flexibility, it should be taken into account that they are not visible in the short term and are therefore difficult to evaluate in just one year by such simple indicators as used in our analysis. A more in-depth analysis of the effects requires a longer period, which would enable the use of econometric methods to extract other factors and identify solely the impact of the reform. Nevertheless, it can be said that by reducing employment protection the reform established the conditions for increasing labour market flexibility in Slovenia.

4 Challenges

In view of the deteriorating conditions and growing structural problems on the labour market, one of the main challenges for economic policy is to develop a set of measures that will increase employment. In order to improve the situation on the labour market, it is necessary to revive economic activity to increase the demand for labour. This means that, in addition to further structural reforms, efforts should be focused on creating an environment that fosters entrepreneurship and attracts foreign investment, as well as on fiscal consolidation and effective stabilisation of the banking system. The analysis of the effects of the changes in labour market regulation based on selected indicators shows that last year's changes were indeed a step in the right direction. However, they are only part of the reforms needed to make the labour market more responsive to changing demand. Improving competitiveness will require further reforms, not only in employment relationships as last year, but also in the wage-setting system and labour taxation.

In order to address the problem of labour market segmentation and increase the responsiveness of the labour market to the crisis, it is necessary to design the incomplete sets of the labour market reform and change certain labour market institutions. The amendments made in the field of permanent employment protection were aimed at increasing flexibility. However, as another objective of the reform was to reduce labour market segmentation, other amendments were also adopted that may work in the opposite direction and reduce flexibility (such as the introduction of severance payments for fixed-term employment and quotas for hiring agency workers). The amendments are thus a consequence of pursuing two different primary objectives (increasing flexibility and reducing segmentation) and, at the same time, the trade-offs in negotiations between the social partners. Even though some indicators show progress towards the set goals, segmentation and flexibility remain a problem. A major factor in the strong segmentation of the labour market in Slovenia is student work, so a different arrangement of student work is another challenge that needs to be addressed. In this respect, it is, however, necessary to consider that student work accounts for a large share of youth employment and that serious restrictions in this area could significantly exacerbate the situation of young people on the labour market and, at the same time, limit the flexibility of employers. In any case, student work should be more closely tied to gaining experience, as this would have a positive effect on the future career development of students/pupils and facilitate their transition to employment.

Given that in the year after the reform was passed the share of people in an employment relationship declined, while the share of self-employed people increased, it will be necessary to resolve the problem of economically dependent workers and re-define the self-employment incentives. However, to enhance the responsiveness of the labour market to the crisis situation, it will also be necessary to reform other labour market institutions, particularly with the view to increasing the efficiency of ALMPs and the functioning of the Employment Service and creating a more responsive wage-setting system.

In light of the significant structural problems on the labour market, another challenge is to strengthen and increase the efficiency of ALMPs. The possibility of integrating workers in vulnerable employment[36] into life-long career counselling, which was introduced last year, increases the significance of programmes that prevent transition into unemployment, but the incentives meant to enable faster entry into new employment (i.e. already during the notice period) have not been successfully put into practice. In view of the peculiarity of the solution (the indirect payer being the worker) and the complicated administrative procedure, this arrangement should be redefined. In 2013 the participation rates of people older than 50 and low-skilled people, i.e. those who have great difficulty finding a new job if they become unemployed, increased the most. From the perspective of eliminating structural imbalances and increasing employment opportunities for these groups, this is, however, favourable, but the participation rates of older people and low-skilled people are still relatively low. With increasing very long-term unemployment, it is also necessary to develop and expand the programmes that prevent transition into long-term unemployment and on-the-job training programmes in cooperation with employers. In order to reduce structural imbalances in the short term, it would be reasonable to increase the role of ALMP programmes in the field of education and training and make sure that they match employers' needs. As a more systematic solution, a system for monitoring and anticipating employers' needs for skills and knowledge in the short and long term should be established.

The significant deterioration in the situation of young people on the labour market during the crisis calls for measures aimed at improving the employment opportunities of the young. Slovenia is one of the countries where youth unemployment increased the most during the crisis. The mismatch between the demand for and supply of tertiary-educated graduates by field of education and the considerable increase in the number of graduates in 2008–2011 escalated the problems of young graduates in transition from education to employment. Such mismatches also exist at the levels of upper secondary and vocational education. Given the ageing population and investment in education, it is necessary to prevent a brain drain and put the knowledge and skills of young people to productive use. For several years now, the analyses of youth unemployment have called attention to the mismatch between the education programme network at the levels of upper secondary and tertiary education and labour market demands. The enrolment of young people in vocational and professional programmes for which there is stable demand has declined, but their participation in tertiary education has risen significantly. However, by enrolling in tertiary-education programmes young people have been postponing their entry into the labour market rather than improving their chances of employment. The latter is the key problem of Slovenia's education system, which should be addressed by education and employment policymakers in cooperation with social partners, particularly employers. Only by including employers in the preparation and implementation of education programmes will it be possible to ensure quality and professional education of young people and their transition to employment through traineeship and similar schemes of practical career training. Increasing the employment prospects of the young will require effective implementation of the Youth Guarantee scheme. In this regard, it is also necessary to evaluate the effectiveness of incentives for hiring young people, which are now governed by several different laws.

In order to increase the employment rate of older people, the pension reform will have to be complemented by other measures. The employment rate of older people in Slovenia is the lowest in the EU, although it rose slightly in the year after the adoption of the pension reform. The pension reform will have to be combined with other measures, such as providing suitable working conditions for older workers and establishing a connection between the employment of younger and older workers. The Act Amending the Labour Market Regulation Act (ZUTD-A), which entered into force in July 2013, allows time-limited and occasional work of pensioners, but employers availed themselves of this option only modestly in the first year of implementation. In order to increase the employment rate of older people, it would be sensible to bring together older and younger generations through the temporary and occasional work of pensioners to facilitate the exchange of knowledge. The new Pension and Disability Insurance Act is slightly

[36] These are workers during the time of the notice period.

more flexible with regard to part-time employment than the previous one (ZPIZ-1), but for it to be used more widely this option will have to be recognised as mutually beneficial by both workers and employers. Part-time retirement provides opportunities for cooperation between young and older workers and allows for intergenerational knowledge transfer. By facilitating the integration of young people into work while promoting a gradual exit of older people from work to retirement, Slovenia could simultaneously address two problems, youth unemployment and the low employment rate of older people. As to the tax allowances for hiring/retaining older employees, it is necessary to reconsider their level and assess if all of them are rational.

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III.
Corporate indebtedness and deleveraging

Summary

In the pre-crisis period, Slovenia, like other EU economies, recorded its most extensive debt accumulation before the crisis, reporting higher credit growth than the PIIGS. Just before the crisis, credit growth reached nearly 35% at the annual level. As a result, Slovenia recorded an above-average decline in lending activity during the financial crisis, and in the last few years this has been comparable to that in other more vulnerable countries in the euro area. The main reasons for higher credit growth were, as in other EU countries, inflated real estate prices, underestimation of uncertainty and lax lending standards, in addition to inappropriate development policies in the past, which were based on development by means of domestic equity. However, its level was much too low for a faster narrowing of the development gap, so the economy gave priority to foreign sources of debt financing rather than foreign ownership. Indeed the supply of these sources expanded after Slovenia's accession to the EU and with the favourable economic conditions in general. Moreover, the concept of the national interest gained popularity in this period, and through various holding companies, assisted by domestic banks, this enabled management buyouts in Slovenian companies and additionally increased their indebtedness. The high dependence of Slovenia's economy on foreign sources of finance has also been a significant factor in the deterioration of the general economic conditions in recent years, as companies have mainly had to deal with financial problems instead of focusing on their core activity.

The significant decline in lending activity after the onset of the crisis was also attributable to the bad situation in the banking system, for which reason the stabilisation of banks was carried out in 2013 on the recommendation of the EU Council. After the recapitalisations, the capital position of the Slovenian banking system improved for the first time since the tightening of the financial crisis, which has had a positive effect in terms of easing the financial constraints faced by Slovenian companies. The positive impacts of bank stabilisation have also been seen this year in the improved performance of the banking sector and higher confidence of savers. In the first quarter the banks generated a profit of EUR 56.6 m. The banks also continue to deleverage abroad. In the recent period they have also been reducing their exposure to the ECB.

Corporate indebtedness and deleveraging have been examined in detail based on the AJPES database of annual financial statements of all companies for the 2006– 2013 period. The advantage of this database is that it includes very detailed annual data on business operations. However, these being only accounting data, they do not necessarily provide a fully realistic picture of the actual economic trends. At the beginning of this section we focus on "less common" companies, such as holding, leasing and zero-employee companies, which contribute to the higher financial debt but do not represent a potentially healthy core of the economy that could pull the economy out of recession. In subsequent chapters we focus on "common" companies, analysing their indebtedness and debt concentration.

The less common companies have been deleveraging since the beginning of the crisis and account for almost 40% of financial debt. However, these companies generate less than 5% of value added and employ less than 1% of employees. They represent a significant burden in banks' balance sheets, but the recent recapitalisations of banks have made it easier to restructure their debts and some of them have also been transferred to the Bank Asset Management Company (BAMC), which is additionally easing the pressure of these companies on bank non-performing loans.

In 2013 over-indebted common companies accounted for around three quarters of bank and financial debts and slightly more than half of the total debt of common companies, and represented a third of the total number of companies and employees. They generated a quarter of value added and accounted for a tenth of total EBITDA. We regarded as over-indebted those companies whose financial debts exceed EBITDA by a factor of five and those that have debts and negative EBITDA. In 2013 more than half of the financial liabilities of over-indebted companies were concentrated in the sectors of wholesale and retail trade and the repair of motor vehicles, in manufacturing and in professional, scientific and technical activities. These three sectors account for as much as EUR 13 bn of financial debt. High shares are also recorded in construction, real estate and electricity, gas and steam supply activities, particularly by micro enterprises (80%) and enterprises oriented to the domestic market (90%). The debt is highly concentrated, with the thirty most indebted companies accounting for a third of the financial and total debts of over-indebted companies.

However, Slovenia also has a healthy core of common companies, which did not over-borrow during the crisis and managed to return to normal, or even improve, their business operations soon after the fall in demand

in 2009. Some of them have been increasing both employment and their wage bill in the recent period. These include several export companies.

Deleveraging of common companies has been observed since 2009, at first largely as a result of the winding-down of companies, while in 2012 and 2013 it was also due to actual debt reductions. Financial liabilities had already started to decline in 2010, but mainly due to the closures of failing companies. Financial liabilities of surviving companies declined for the first time only in 2012, by EUR 0.4 bn, and by a further EUR 0.5 bn in 2013. Similar dynamics were seen in financial liabilities to banks: common enterprises were deleveraging only in the last three years, while in the first two years of the analysed period their bank debts had remained unchanged.

Empirical analysis has shown that unexpected and exogenously induced corporate deleveraging during the recession adversely affects economic activity, as a general decline in demand and banking system problems exacerbate the financial constraints on companies**.** Under such circumstances, deleveraging can mean for the most part a decline in investment activity. This is also corroborated by the analysis of investment trends and various financial indicators. Companies with high interest payments and large financial debts have lower investment rates than less indebted companies. In 2009 investment activity declined across all size classes, notably in micro and small enterprises.

International comparisons show that Slovenian companies are more indebted relative to GDP than those in economically stable euro area countries. At the same time, they have very low shares of equity in total liabilities and hence excessive debts. Both data indicate a need for the continuation of the deleveraging process, which began during the financial crisis. However, the Slovenian economy is still in the phase of recession and, according to our econometric analysis, a rapid reduction in financial leverage will have an adverse impact on investment activity and economic growth. To minimise the negative short-term effects of deleveraging on economic activity, it is therefore necessary to use deleveraging tools that are not focussed primarily on direct loan repayment but that also provide additional equity. In a period when this is difficult to achieve through the capital market, this involves a more intensive use of the debt-for-equity swap mechanism or a partial write-off of debt, followed by privatisation, where the BAMC should play an active role.

Additional capital should be mainly obtained from private – both foreign and domestic – sources of finance, while the state's ownership role should be reduced and an ownership structure put in place 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 the past in our assessment.

The provision of fresh capital on the market and the deepening of financial markets would also be facilitated by additional financial incentives for financial investors, such as additional tax allowances for pension funds, and promoting the importance of old-age saving. Improving the financial structure of enterprises will also involve ensuring the functioning of other segments of financial services that are mainly based on long-term sources of finance. The instrument of securitisation could also be used, so that larger and more financially stable enterprises could also seek funding under more favourable conditions on other financial markets.

Introduction

This part analyses the indebtedness and financial structure of Slovenian companies and their interdependence with macroeconomic developments. The financial crisis that hit Slovenia in 2008 negatively affected – through financial and credit channels – capital formation and the related economic activity or inactivity of Slovenian companies. Despite deleveraging that has been in place ever since the beginning of the crisis, Slovenian companies are still relatively highly indebted, which is the main obstacle to development. The state actively engaged in solving this problem only in 2013 through the restructuring of the banking system. This part of Economic Issues analyses at both micro and macro levels (i) the implications of the financial crisis for Slovenia compared to other European states, (ii) bank restructuring, (iii) the structure of corporate indebtedness and its impact on capital formation, (v) the most indebted companies and debt concentration and (iv) the macroeconomic impacts of corporate indebtedness and deleveraging.

It is structured as follows. The first chapter compares the credit markets in Slovenia and EU Member States. The second chapter describes the banking system. The third analyses corporate indebtedness and deleveraging based on corporate balance sheets. The fourth chapter provides an empirical assessment of the impact of deleveraging on capital formation and economic growth, while the final chapter presents future challenges.

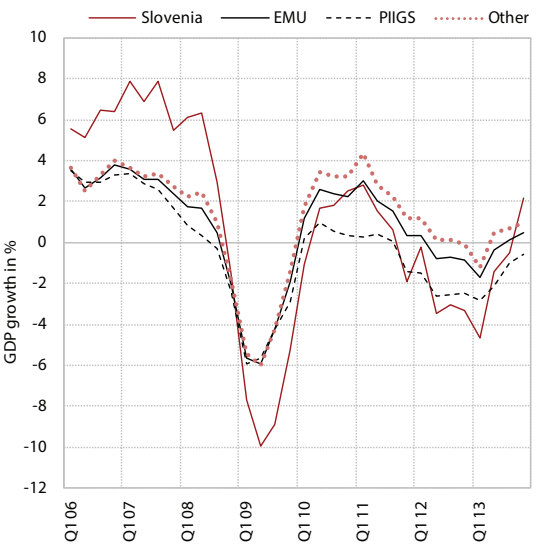
1 Credit markets in Slovenia and international comparison

In the pre-crisis period, EU economies recorded one of the most extensive debt accumulations of non-financial corporations in recent history. The economic reasons for such high growth rates include inflated real estate prices, underestimation of uncertainty, and lax lending standards. The size of debt and the deterioration of the corporate capital structure were among the factors that significantly affected the progress of the financial crisis, the slowdown of economic activity and the pace of economic recovery. While debt, if moderate, has a positive effect on economic growth and prosperity, this cannot be said of high debt rates which, on the contrary, create the conditions for financial instability and hinder investment, thus slowing down economic growth. The borrowing dynamics and GDP movements in the euro area confirm the theory that excessive debt accumulation increases the probability of financial crisis.

Data also reveal that those countries with lower debt accumulation in the pre-crisis period recorded lower deleveraging during the crisis, which means less volatility of indebtedness and more stable conditions for investment and growth. It should be underlined that the reduction of financial leverage in the time of crisis was also related to the fall in economic activity and, as a consequence, less corporate capital. Such logic is also confirmed by micro data suggesting that those companies with higher debt decrease capital formation in order to repay their financial liabilities, which means that a future reduction of cash flow resulting from the repayment of debt has a negative impact on corporate spending and investment decisions in the event of a slowdown of economic activity. Lower liquidity, high interest margins as well as high indebtedness thus go hand in hand with a significant decline in investments during the crisis and have resulted in slower economic recovery.

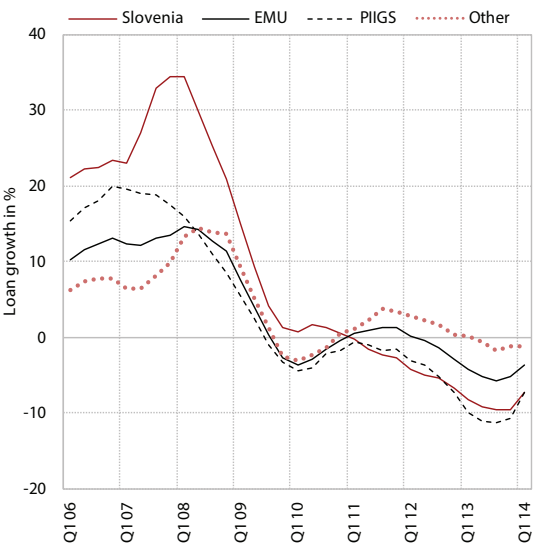
During the crisis, Slovenia recorded an above-average decline in lending activity, which in the past three years was comparable to other exposed EMU countries. One reason for this is that in the pre-crisis period, loan growth in Slovenia had been higher than the PIIGS average, reaching nearly 35% at the year-on-year level just before the onset of the crisis. As in the entire EU, high debt accumulation before the crisis had been due to a number of managerial buyouts where internal owners, assisted by state-owned banks and in the name of national interest, consolidated ownership and financially wore out the companies. Even before the start of the restructuring of the banking system, banks had no longer been able to take additional risks and thus reduced exposure to their clients, which triggered strong liquidity pressures on the Slovenian economy, which depends largely on bank debt financing.

Figure 1: **GDP growth in Slovenia, EMU, PIIGS[1] and other countries[2]**



Source: Eurostat.

Figure 2: **Year-on-year growth rates for loans to non-financial corporations in Slovenia, EMU, PIIGS and other countries**

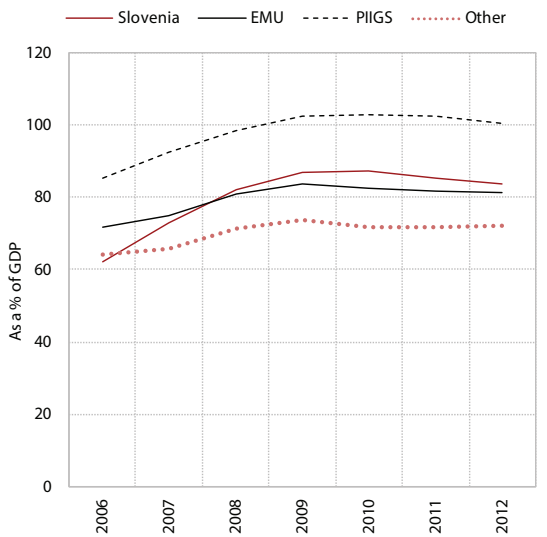


Source: ECB; calculations by IMAD.

[1] PIIGS countries include Portugal, Italy, Ireland, Greece and Spain.
[2] »Other countries« include all other EMU members with the exception of PIIGS.

As regards the indebtedness of non-financial corporations as a share of GDP, where debt includes debt securities and loans[3], ***Slovenia does not deviate much from the EMU average.*** The level of indebtedness of Slovenian non-financial corporations is slightly lower than in exposed EMU countries. If the debt of non-financial corporations was expanded to include other liabilities (trade credits, advance payments, etc.), it would come much closer to the PIIGS levels (it would lag behind by less than 5 percentage points). Owing to the restructuring of the banking system in 2013, corporate indebtedness significantly decreased; their debt as a share of GDP is below the EMU[4] average, while the rate of indebtedness only slightly exceeds the average of "other countries".

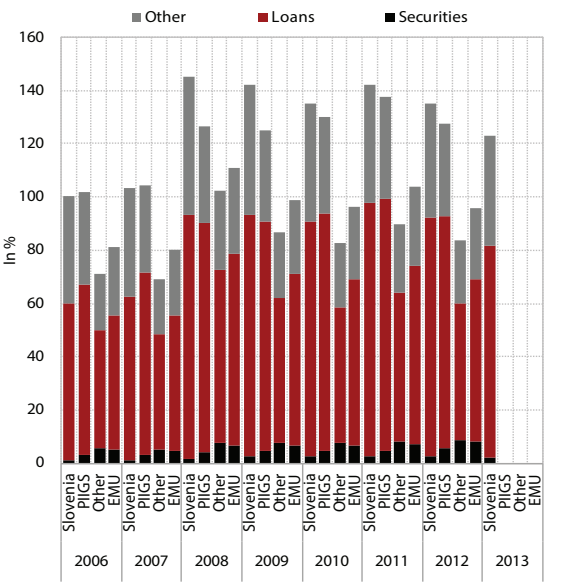
Figure 3: **Indebtedness of non-financial corporations relative to GDP, 2006–2012**



Source: Eurostat; calculations by IMAD.

As regards the ratio of debt[5] ***to equity, Slovenian non-financial corporations are among the most heavily indebted in the euro area.*** Although the volume of loans taken out in domestic banks decreased considerably in the past four years (by about a third) and is already a fifth lower than in 2007, the indebtedness of the Slovenian economy is still much above the pre-crisis level. This is mainly a result of significant equity shrinking in response to the negative trends on capital markets; in addition, the corporate business results did not enable any strengthening of the equity base of the economy. The only companies more indebted in 2012 than Slovenian companies were those in Malta, Latvia and Greece. Total corporate indebtedness measured as debt-to-equity ratio fell more markedly last year and equalled 123.1%, which is 12.6 percentage points less than in 2012. A large share of the decrease in 2013 was mainly due to further deleveraging of non-financial corporations as capital increased by less than one percent. In our assessment, the deleveraging of the Slovenian economy could be accelerated by greater capitalisation. If the volume of equity in Slovenian non-financial corporations were at the level recorded in late 2007, when it was the highest, the debt-to-equity ratio in non-financial corporations would be quite balanced, although still exceeding the average debt of non-financial corporations in the EMU by about a tenth[6].

Figure 4: **Indebtedness of non-financial corporations by volume of capital, 2006–2013**



Source: Eurostat; calculations by IMAD.

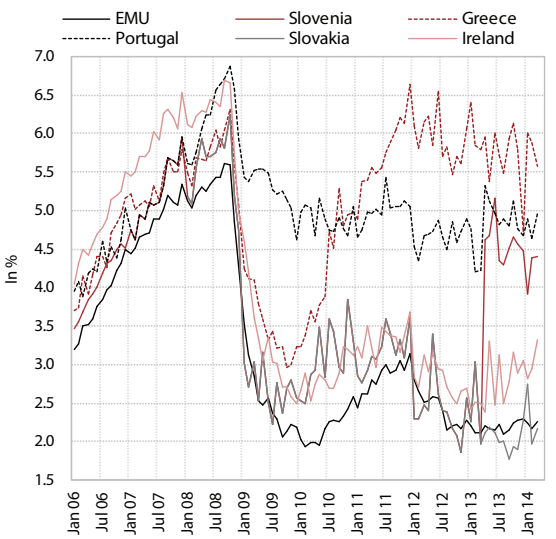
Although the structure of corporate financial liabilities and assets improved slightly in 2013, it remained rather unfavourable compared to EMU countries. The share of long-term financial liabilities[7] accounts for around 70% of the total financial liabilities, which is about a tenth less than the EMU average. The deficit in long-term financial liabilities is most evident in equity and long-term debt securities, i.e. instruments of an explicitly long-term nature that depend on the situation on the capital market. The capital market is relatively shallow and illiquid

[3] Data from consolidated financial accounts.
[4] Data for EMU relate to 2012.
[5] Debt includes the following items of non-consolidated financial accounts: securities excluding shares, loans and other liabilities.
[6] Data for EMU relate to 2012.
[7] Long-term financial liabilities include long-term debt securities, long-term loans and equity.

in Slovenia, which – in addition to company size[8] – also results in lower corporate accessibility to such financing sources. These have recorded an above-average share of long-term loans, which increased markedly in the period of the financial crisis when the banks restructured a part of short-term corporate loans into long-term loans. On the other hand, Slovenian companies have an above-average share of short-term financial liabilities, which implies stronger pressures on corporate liquidity. At the same time, their volume and the share of the most liquid financial assets (cash, deposits and debt securities) are lower than the EMU average. Companies are thus exposed to greater risk of liquidity pressures, and because of a lower share of the most liquid financial assets they are also less resistant to pressures.

The differences between domestic and foreign lending interest rates are still among the highest in the euro area. For such reasons, over-indebted companies continue to be subject to pressures, the competitiveness of the Slovenian economy is weak, and creditworthy companies are reluctant to borrow. Higher interest rates for loans above EUR 1 m apply only in Greece, Cyprus and Portugal. On the other hand, despite having a lower rating than Slovenia, Italy and Spain for example have lower interest rates for corporate loans and lower yield to maturity for state bonds. In recent years, active interest rates in Slovenia have been less responsive to any external impacts than in other EMU countries.

Figure 5: **Active interest rates in Slovenia and selected EMU countries**



Source: BoS, ECB.

[8] Small and medium-sized companies prevail in Slovenia.

2 Banking system stabilisation

Given that the bad state of the Slovenian banking system has been the decisive factor in Slovenia's economic performance being among the worst in the euro area in recent years, it was essential to break these unfavourable trends by stabilising the banking system. The problem of the rapid deterioration in the state of Slovenian banks, particularly in light of the negative feedback loops with the weak economic situation, corporate indebtedness and public finances, was also exposed by the in-depth review of the European Commission published in spring 2013, which ranked Slovenia among the countries with excessive macroeconomic imbalances and on the basis of which the Council issued recommendations for immediate stabilisation of the situation

With the aim of ensuring stability, stress tests of banks, an asset quality review and recapitalisations of the largest banks were carried out in the second half of 2013. The stress tests involved eight banks,[9] comprising a representative sample of the Slovenian banking system. Their results showed that under the adverse macroeconomic scenario,[10] the potential capital shortfall of banks included in the review would reach EUR 4,778 m (13.7% of GDP). On the basis of these results, the government recapitalised the three largest banks in the amount of EUR 2.8 bn[11] (7.9% of GDP) at the end of 2013 and transferred the first package of assets to the Bank Asset Management Company (BAMC). Last year the government also recapitalised the two banks undergoing ordinary winding-down processes in the amount of EUR 445 m. The government has thus already allocated around EUR 4 bn of public funds for banking system recapitalisations since 2008 (11.3% of GDP).

The remaining banks, which recorded capital deficits according to the stress test findings, were given 30 days to lay out a plan for a capital increase, which should be implemented by the end of the first half of the year. If they fail to raise capital, they will

[9] Ten banks had initially been involved in the review, but two were subsequently excluded due to the initiation of orderly winding-down processes.

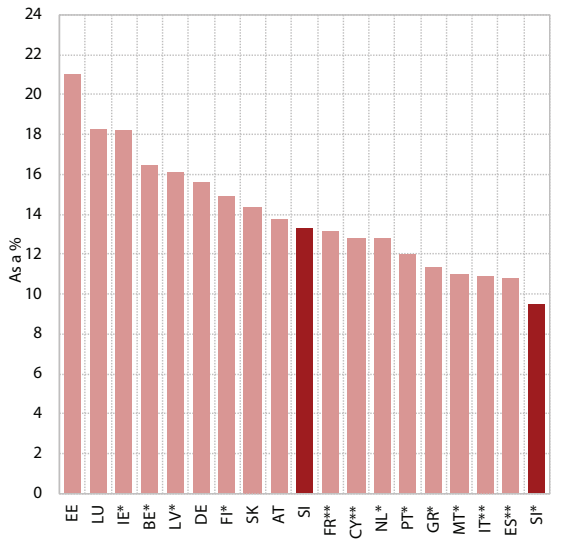
[10] The adverse scenario assumes a 9.5% decline in economic activity in 2013–2015, an 18% decline in private consumption, a 25% decline in gross capital formation and the value of shares, and a 27% decline in the prices of family houses. Public debt is assumed to rise to 84.4% of GDP and unemployment to 14% in this period.

[11] The capital shortfall at these banks totalled EUR 3.7 bn, but the capital requirement declined to EUR 3 bn due to the transfer of claims to the BAMC and the devaluation of subordinated debt holders' assets. Furthermore, one of the banks was not fully recapitalised, as it has not yet received a final favourable opinion from the European Commission.

be able to ask for state aid in accordance with the European Commission's rules. Given the low interest from private investors in recapitalising the remaining domestic-owned banks, at the end of the first quarter of 2014 the government took the decision (at the initiative of Banka Celje and on the basis on the Bank of Slovenia's opinion) that Banka Celje is ready to embark on the procedure for implementing measures under the Measures of the Republic of Slovenia to Strengthen Bank Stability Act (ZUKSB). Regarding Gorenjska banka, the government decided, on the basis of the decision of the Bank of Slovenia, to extend the deadline for the elimination of the capital shortfall by the end of 2014. Taking into account the activities carried out and the capital adequacy situation at Raiffeisen Bank and Hypo-Alpe-Adria Bank, there is no need for a further recapitalisation of these two banks (Report on the Effects of Measures to Strengthen the Stability of Banks).

The main purpose of repairing bank balance sheets was to stabilise the banking system and limit the negative feedback loop between the state of the banking system, the economy and public finances. The first positive effects of the banking system stabilisation showed relatively soon after its initiation (in the higher stability of the banking system, improvement in Slovenia's standing on international financial markets), but the majority (improved access to financing and greater efficiency of financing the Slovenian economy and better access to bank funding via the wholesale financial markets) are expected to become visible only over a longer time period, if coupled with successful implementation of other structural reforms, such as deleveraging the Slovenian economy, privatisation and better corporate governance.

Figure 6: **Capital adequacy (TIER 1) in selected euro area countries at the end o 2013**



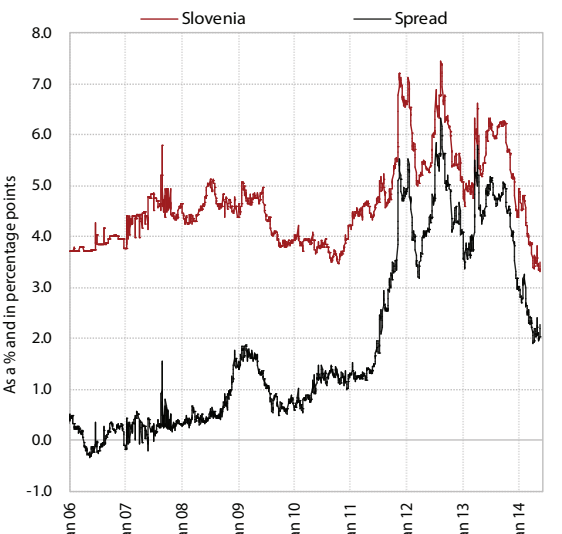
Source: IMF – Financial Soundness Indicators.
Note: **Data for Q3 2013, *** data for Q2 2013.

After the recapitalisations, the capital position of the Slovenian banking system improved visibly for the first time since the tightening of the financial crisis. The Slovenian banking system, having been the most undercapitalised of all euro area countries at the end of the third quarter, ranked among the medium-capitalised banking systems at the end of 2013 as measured by the Core Tier 1 capital ratio. The capital adequacy of the Slovenian banks is thus relatively high, meaning that they can again start lending to creditworthy companies that have promising development projects.

Immediately after the beginning of stabilisation, Slovenia's position on international financial markets improved substantially. Following the measures undertaken by the Bank of Slovenia and the government after the stress test results were released, the yield to maturity of the Slovenian 10-year government bond started to fall and was already around 200 basis points lower in the middle of May (at about 3.5%). Slovenia has thus improved its position on international financial markets and issued a euro bond for the first time since March 2011. For more on this, see the section Fiscal Developments and Fiscal Policy.

With the beginning of banking system stabilisation, the share of arrears over 90 days declined significantly, but it is still much higher than before the crisis. The share of claims that are more than 90 days overdue fell from 17.3% to 13.4% at the end of the year. By the end of the year, their volume fell by EU 2.2 bn to EUR 5.5 bn from the highest level in November 2013. The banks transferred EUR 3.3 bn of non-performing claims to the BAMC. In line

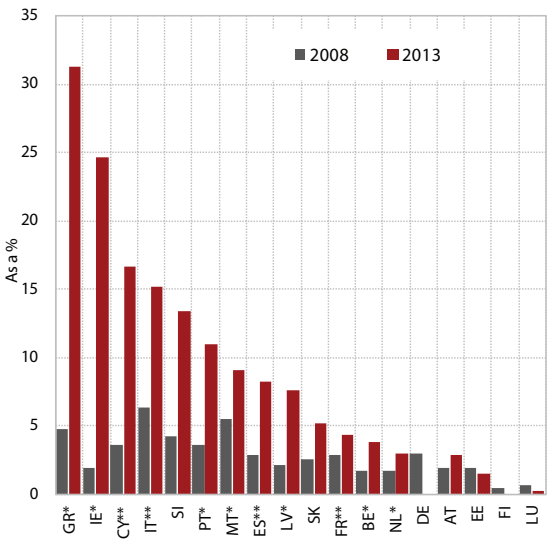
Figure 7: **Yield to maturity of the Slovenian 10-year government bond and spread against the German bond**



Source: Bloomberg; calculations by IMAD.

with expectations, the share of non-performing claims declined most notably in sectors that were more exposed to the crisis (construction, trade and manufacturing), with the exception of financial intermediation, where the share of non-performing claims even rose slightly. The quality of bank assets also improved notably in some other sectors (accommodation and food service activities, information and communication activities), but these were less important with regard to non-performing claims.

Figure 8: **Shares of arrears over 90 days in EMU countries**

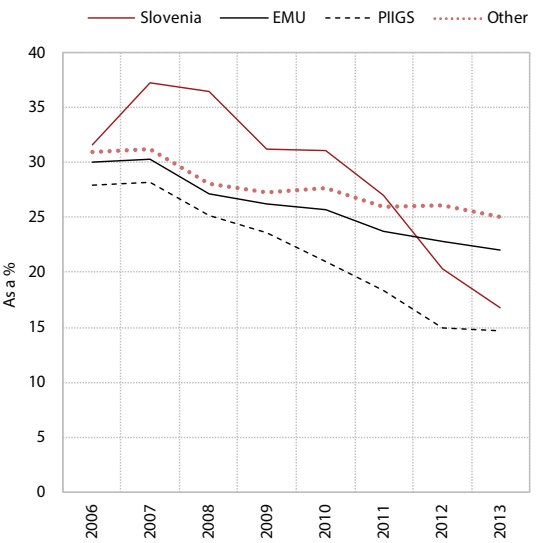


Source: IMF – Financial Soundness Indicators.
Note: * Data for Q3 2013, ** data for Q2 2013.

This year the positive impacts of bank stabilisation have also been seen in the improved business performance of the banking sector and higher confidence of savers. In the first quarter the banks generated a profit of EUR 56.6 m. Net interest receipts also rose, by a solid 5%. The improvement in business results was, in addition to the beginning of banking system stabilisation, also attributable to a considerable decline in passive interest rates, while a more visible reduction in active interest rates has yet to be seen. Household confidence in banks declined significantly in view of the poor state of the Slovenian banking system and the adverse financial situation in Cyprus, which showed in a rapid fall in household deposits in 2013, before they started to rise again in the first quarter of 2014. According to our estimate, household deposits in particular will be a fairly important source of funding for the banking system in the future, as they proved to be the most stable when the conditions on international financial markets started to deteriorate, while resources from interbank financial markets proved very unreliable, due to which the Slovenian banking system remains under liquidity pressure.

While continuing to deleverage abroad, the banks have also been reducing their exposure to the ECB in the recent period. The exposure to the ECB declined by around EUR 850 m from the beginning of the banking system stabilisation until the end of March. The repayment of the banks' foreign liabilities otherwise slowed slightly in 2013, but was still relatively significant at EUR 2.1 bn. Foreign liabilities accounted for around 17% of total bank assets at the end of the year. In the first quarter the banks continued to deleverage abroad, their net repayments amounting to just over EUR 200 m. The dependency of the Slovenian banking system on foreign funding is already below average, which will, given its successful stabilisation, lead to a gradual improvement in access to foreign sources of finance, so that their share would no longer decline and hamper the lending activity of banks. This is, in fact, still very low, which can be explained by several factors: (i) a significant portion of the Slovenian economy is over-indebted; (ii) lending interest rates are still among the highest in the euro area; (iii) the banks continue to be under relatively strong liquidity pressure; and (iv) the banks are facing the risk of a further deterioration in the quality of their assets. The risks to the banking system are associated with loans to those customers that, owing to weak economic activity, are no longer capable of settling their liabilities when they become due, which could, once again, translate to higher growth in non-performing loans. A further decline in the quality of bank assets would deteriorate the situation in the banking system again, which would have a negative impact on the entire economy. In the following chapters we therefore analyse the indebtedness of the Slovenian economy, its debt structure and deleveraging, including the impact on investment and economic growth.

Figure 9: **Foreign liabilities as a share of banks' total assets in Slovenia and selected EMU countries**



Source: World Bank, BoS; calculations by IMAD.

3 Indebtedness of the corporate sector

Various indicators point to excessive indebtedness of the Slovenian economy, which in our assessment represents a major risk to further economic recovery. Over-indebtedness is a consequence of inappropriate development policies in the past, which were based on development by means of domestic equity. However, its level was much too low for a faster narrowing of the development gap, so the economy gave priority to foreign sources of debt financing rather than foreign ownership. The supply of these sources in fact expanded after Slovenia's accession to the EU and with the generally favourable economic conditions. Also the concept of the national interest gained popularity in this period, and through various holding companies, assisted by domestic banks, this enabled management buyouts in Slovenian companies and additionally increased their indebtedness. The high dependence of Slovenia's economy on foreign sources of finance has also been a significant factor in the deterioration of the general economic conditions in recent years, as companies have mainly had to deal with financial problems instead of focusing on their core activity.

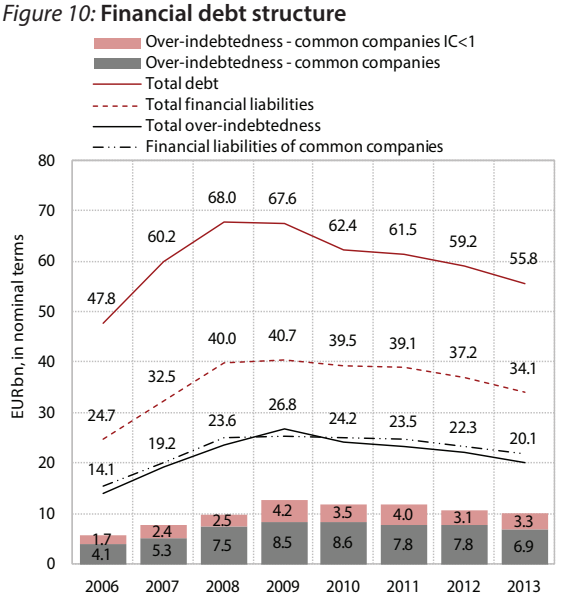
Indebtedness has been examined based on individual data from the balance sheets and profit and loss accounts of all Slovenian companies, gathered by the Agency for Public Legal Records and Legal Services (abbreviated name: AJPES) for the period 2006–2013[12]. The advantage of this database is that it includes very detailed annual data on business operations. However, these being only accounting data, they do not necessarily provide a fully realistic picture of the actual economic trends. The problem of corporate indebtedness became increasingly pressing with the onset of the crisis. Considering that a healthy financial position of companies is crucial to sustainable economic revival, several analyses have already been made in this regard for Slovenia. Our analysis is indeed the first to examine data for 2013 and transparently present the results with due account of the various "deletions" from the database. The structure of the present chapter is as follows. First, we provide an overview of the indebtedness of all companies included in the AJPES database. Second, we present the indebtedness and operation of holding, leasing and zero-employee companies. Such companies contribute to the higher financial debt but do not represent a potentially healthy core of the economy that could pull the economy out of recession. In subsequent chapters we focus on "common" companies, analysing their debt structure and the basic indicators of profitability, liquidity and operations. Among these, we will identify the most heavily indebted companies and financial debt concentration.

[12] 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 excluded »common« companies, i.e. companies other than holding, leasing and zero-employee companies and DARS (the Motorway Company of the Republic of Slovenia), as they could distort the actual picture of Slovenian corporate borrowing. The 2013 sample thus included 38,209 common companies and 61,312 of all companies.

3.1 Indebtedness of the entire corporate sector

Indebtedness[13] peaked in 2009 when it was nearly twice as much as in 2006; ever since, companies have been constantly reducing their debt and have managed to achieve the 2007 level. Prior to the crisis, overall[14] and financial debt increased as well; in 2008, they grew by 42% and 62% respectively compared to 2006. Over-indebtedness of common companies follows the deleveraging trends for all companies, but there is a considerable difference in the amount: at EUR 10.2 bn in 2013, over-borrowing of common

Figure 10: **Financial debt structure**



Source: AJPES, calculations by IMAD.
*Over-indebted companies are companies whose financial debts exceed EBITDA by a factor of five. +Over-indebtedness – common companies means companies other than holding, leasing and zero-employee companies and DARS (the Motorway Company of the Republic of Slovenia). #Over-indebtedness – common companies IC<1 stands for financial debt of companies that are over-indebted and have an interest coverage ratio (EBITDA/interest) lower than 1.

[13] Over-indebtedness is measured as a sum of financial liabilities exceeding five times EBITDA.
[14] Overall debt comprises financial, operational and other liabilities of companies.

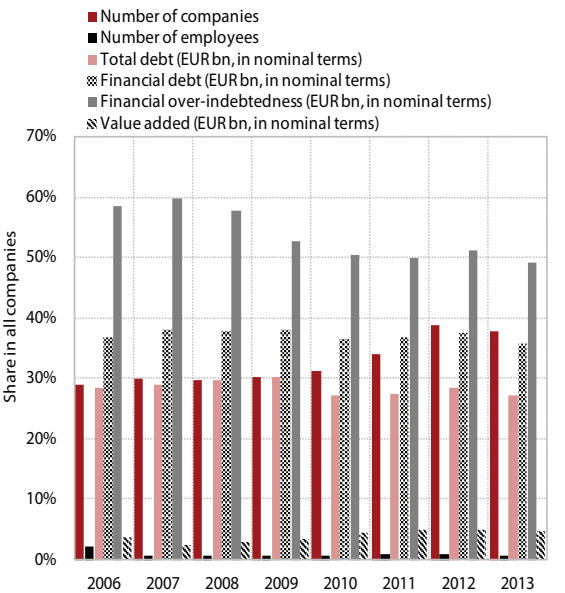
companies is half that of total indebtedness. EUR 3.3 bn of that value relates to debt where interest coverage (EBITDA/interest) is less than 1, which means that companies are unable to finance such debt with their current operations. Moreover, 70% (EUR 2.3 bn) relates to debt where the companies have both debts and a negative EBITDA. Considering that nearly half of over-indebted companies are holding, leasing or zero-employee micro companies, we will first look at their role in the economy and after that proceed with the analysis of common companies i.e. those seen as key drivers of economic activity.

3.2 Holding, leasing and zero-employee companies and the Motorway Company of the Republic of Slovenia

Given that holding, leasing and zero-employee companies and the Motorway Company of the Republic of Slovenia account for as much as 35.8% of financial debt (approximately EUR 12 bn), this category indeed represents a significant burden in banks' balance sheets[15]. The recent recapitalisation of banks has however made it easier to restructure their debts and some of them have also been transferred to the Bank Asset Management Company (BAMC), which is additionally easing the pressure of these companies on bank non-performing claims. Zero-employee companies, which represent 37% of all companies, contributed EUR 4.1 bn to the above amount of financial debt, whereas the share of holding and leasing companies, accounting for less than one percent of the total, was as much as EUR 5.3 bn. On the other hand, the aforementioned companies generate less than 5% of value added and employ less than one percent of the total headcount in companies.

Given their specific role and ownership structure as well as their insignificant contribution to economic growth, such companies were excluded from further analysis. In the pre-crisis period, financial holdings were actively involved in the second privatisation wave that took place in Slovenia, partly because of the many management buyouts. With the assistance of state-owned banks and the companies such holdings control, internal owners consolidated their ownerships in individual activities and financially often completely drained the companies in their group. As a consequence, many holdings are insolvent or engaged in a debt restructuring process. Given their specific role and ownership structure as well as their insignificant contribution to economic growth, such companies require special treatment and were thus excluded from further analysis. Leasing companies were excluded for a similar reason, as their operations differ from the operations of common companies. Zero-employee companies are a specific category as well: these are companies without capital, established for a specific purpose e.g. for restructuring purposes, companies in bankruptcy, etc. "Uncommon" companies have on average a 59-times higher financial leverage[16], 7-times lower interest coverage and a negative return on assets.

Figure 11: **Share of holding and leasing companies in overall and financial debt, in the number of employees and value added, and in the total number of companies**



Source: AJPES, calculations by IMAD.

3.3 Indebtedness and operation of common companies

Deleveraging of common companies has been observed since 2010, at first largely as a result of the winding-down of companies, while in 2012 and 2013 it was also due to actual debt reductions. Financial debt[17] had already started to decline in 2010, but mainly due to the closures of failing companies[18]. The financial debt of surviving companies declined for the first time in 2012, by EUR 0.4 bn, and by a

[15] Data do not allow a distinction between domestic and foreign banks.

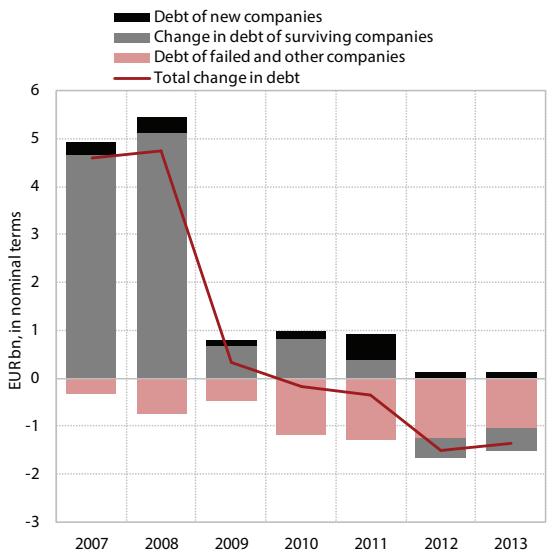
[16] Financial leverage is measured as a ratio between financial debt and EBITDA.

[17] Financial debt means all financial liabilities of companies.

[18] It is not possible to clearly identify which companies went bankrupt and which ceased to operate for other reasons. The companies that ceased to operate are those that in a given year are no longer listed in the AJPES database.

further EUR 0.5 bn in 2013. Over the past two years, new companies have been increasing their debt by EUR 0.1 bn per year, which is EUR 0.4 bn less than in 2011. A similar dynamic has been observed in financial liabilities to banks: common companies have been deleveraging only in the last three years, while in the first two years of the analysed period their bank debts had remained unchanged. Corporate financial liabilities to banks decreased in the past three years by EUR 3.7 bn in cumulative terms: the debt of new companies amounted to only EUR 0.2 bn, EUR 2.6 bn was generated by the winding-down of companies, while the actual deleveraging of surviving companies amounted to EUR 1.4 bn.

Figure 12: **Deleveraging structure in common companies**



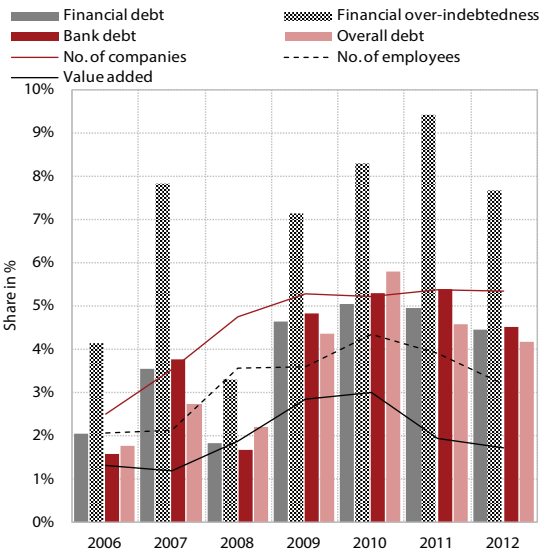
Source: AJPES, calculations by IMAD.

3.3.1 Analysis of common companies that ceased to operate

The number of common companies that failed remains unchanged ever since 2009 and represents 5% of all common companies and 3% of all the persons employed in common companies. In 2012, these companies generated around 4.5% of bank and financial debt as well as of overall debt. Interestingly, their share in the bank debt is increasing, the share in financial debt remains the same, while in overall debt their share is decreasing. This is due to the fact that these companies were facing a demand shock that negatively affected i.e. reduced their operating liabilities. Most companies that failed were micro[19] companies. In 2012, however, their number shrank similarly to the number of medium-sized and large

[19] Micro companies have 1–5 employees.

Figure 13: **Share of debt, its components, value added and headcount of common companies in overall debt, its components, value added and headcount in 2008–2012**

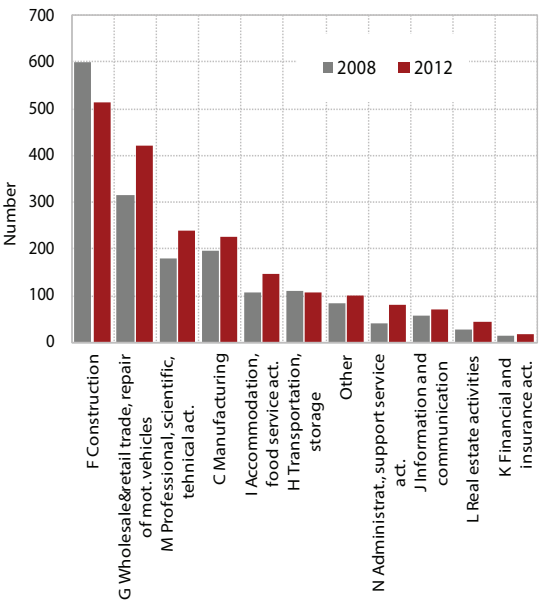


Source: AJPES, calculations by IMAD.

enterprises, while the number of small enterprises increased.

Deleveraging as a result of the winding-down of companies was most pronounced in the sectors of construction and in wholesale and retail trade and repair of motor vehicles. High shares are also

Figure 14: **Number of failed common companies by activities**



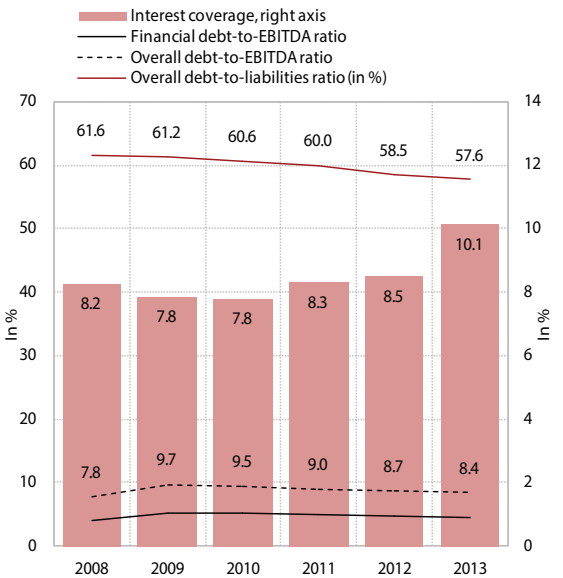
Source: AJPES, calculations by IMAD.

recorded in professional, scientific and technical activities. The above sectors also feature the largest number of over-indebted companies. In fact, during the period of crisis, most companies that failed originated from the above sectors, which account for 69% of total employment and in 2013 generated 68% of value added.

3.3.2 Operation and deleveraging of common companies

The past three years have seen an improvement of companies' ability to pay off their debts. The total debt to EBITDA[20] ratio has been improving since 2011 and reached 8.4 in 2013; likewise, interest coverage[21], measuring the ability to pay off debts, has been improving for the third consecutive year and in 2013 amounted to 10. The ratio of financial debt to EBITDA (financial leverage – FL[22]) since 2010 also points to deleveraging, with FL equal to 4.5 in 2013. Considering that indebtedness is relative, its interpretation also relies on EBITDA. In the first crisis year EBITDA fell by nearly 21%, which had an immediate negative effect on corporate indebtedness measured by FL. The shock was felt by all companies, particularly those that are less indebted (FV<5) and generate most EBITDA. The latter have been gradually increasing EBITDA since 2011 and thus improving their financial position, whereas in over-indebted companies (FL>5) EBITDA decreases with a negative impact on their indebtedness.

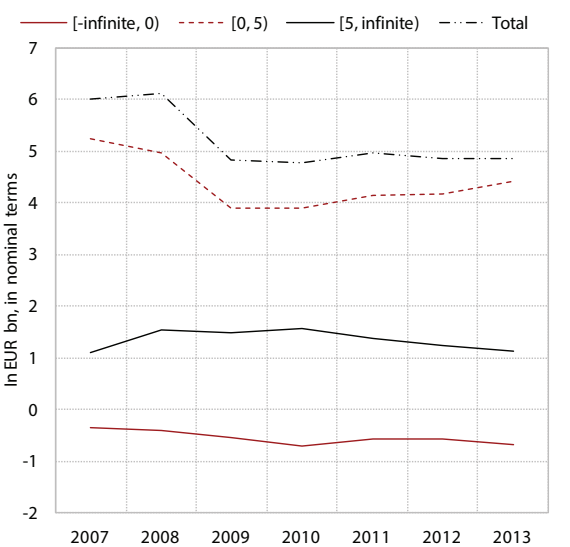
Figure 15: **Share of debt in total liabilities (in %), leverage and interest coverage of common companies in the private sector, 2008–2013**



Source: AJPES, calculations by IMAD.

Deleveraging takes place mainly in heavily indebted firms, which means that the most problematic companies either ceased to operate or actually repaid their debts. Moreover, there are several indebted companies with a negative EBITDA that are presumably kept afloat by state aid or debt reprogramming. In less indebted companies (FV<5), there is an evident link between financial debt and EBITDA. No such link is clearly visible among over-indebted companies (FV>5) although in the most indebted companies (FV>10) EBITDA continues to decrease, which means that in addition to intensive deleveraging these companies also face lower demand, further hindering their recovery. As regards companies with a negative EBITDA, the least indebted record the largest share of the overall negative EBITDA. This means that their main problem is not over-indebtedness but rather issues related to their operations. Value added follows a trend similar to EBITDA. Less indebted companies (FV<5) generate most value added, which further increases over time, whereas the decline in value added is most accentuated among the most indebted companies.

Figure 16: **Comparison of EBITDA and indebtedness in 2007–2013**

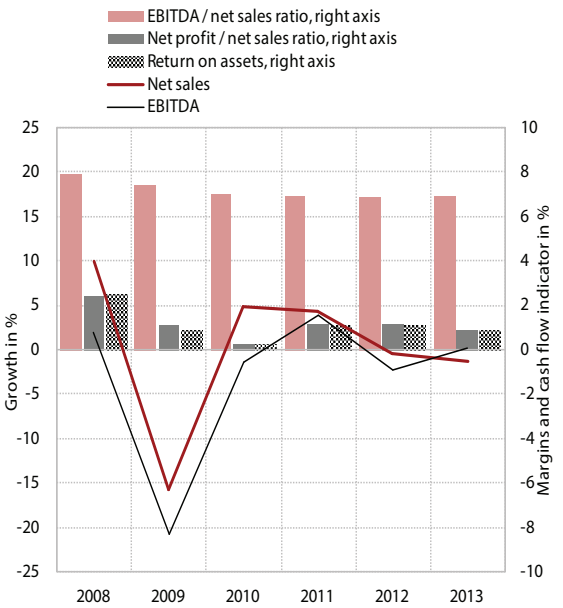


Source: AJPES, calculations by IMAD.

[20] EBITDA is defined as earning before interest, taxes, depreciation and amortisation.
[21] Interest coverage is calculated as share of EBITDA in interest costs.
[22] Financial leverage has two thresholds and a distinction is made between companies with negative EBITDA and FL<0, companies with 5>FV>= 0, and over-indebted companies with FV>5.

In addition to EBITDA, net sales and profitability of companies also declined significantly in the first crisis year. Both of these factors improved in 2011 only to decrease again in 2012 and 2013 following the deterioration of the economic situation. In 2013, net sales were down by 1.3% while EBITDA slightly increased (0.1%).

Figure 17: **Profitability of common companies in the private sector, 2008–2013**

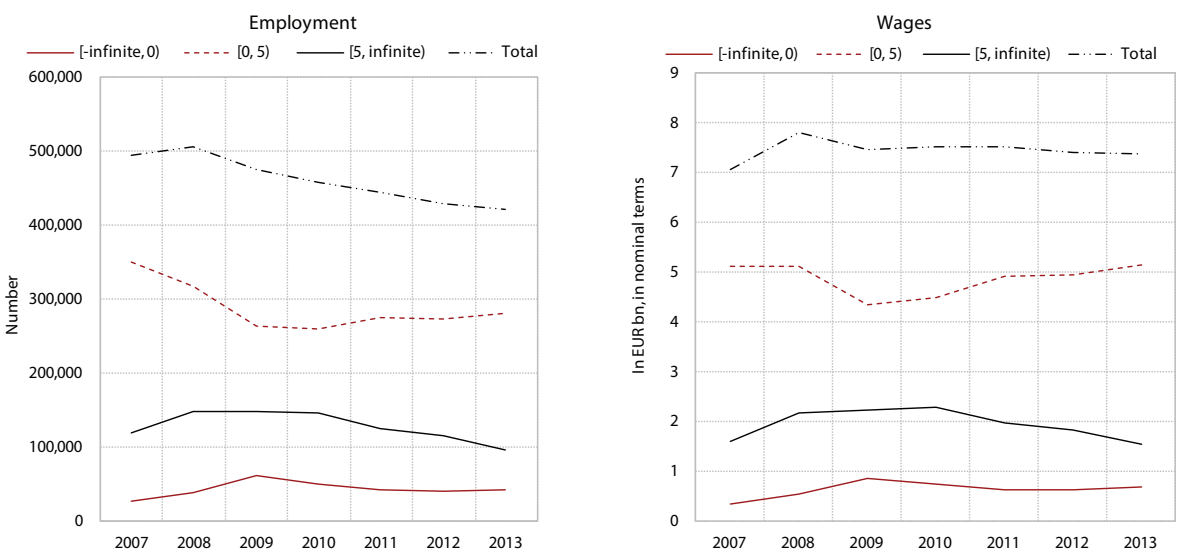


Source: AJPES, calculations by IMAD.

Companies adjusted to the initial decline in value added, EBITDA and indebtedness and the gradual recovery of value added and EBITDA, resulting in further deleveraging, by adjustments on the labour market. After the fall in 2009 and the temporary increase in 2010 as a result of the legislated rise in the minimum wage, the total wage bill in common companies has been slowly decreasing in the past three years. This is due more to lower employment than to lower wages. Adjustments in the labour market among different groups of companies are similar and show a parallel trend in wage bill and employment costs. In the past three years, less indebted companies (FV<5) recorded increases in both wages and employment, which means that there is a healthy core of companies capable of further recovery, while on the other hand the more heavily indebted companies (FV>5) faced greater dismissals and a more significant wage bill reduction. For more information see Challenges on the labour market.

Considering the number of companies, there has been a reallocation of sources into export activities, since the number of companies oriented to the domestic market decreased while the number of medium and highly export-oriented companies rose. The number of non-exporters declined most notably in 2012, related mainly to the most indebted companies. The number of moderately indebted companies (FV<5) remained almost unchanged. On the other hand, the number of export-oriented

Figure 18: **Wage bill and employment costs in 2007–2013**



Source: AJPES, calculations by IMAD.

companies has been growing for the fourth year in a row, with the number of mainly export-oriented companies rising by as much as 56% since 2008. It is important to note that the growth of both main and moderate exporters was most pronounced among less indebted companies (FV<5). In 2011 and 2012, the number of indebted companies with a negative EBITDA became stable but grew again in 2013.

In 2013, more than half of the overall corporate debt was generated by financial liabilities, mainly liabilities to banks (65%) whose share relative to financial debt fell by 12 percentage points in the analysed period. The decline was most evident in the past two years when bank debt shrank by EUR 4 bn. This was most notable in over-indebted companies, while the bank debt of moderately indebted companies (FV<5) remained unchanged throughout the period. Among over-indebted companies, most debts were repaid by companies with a leverage higher than 10. In terms of maturity, 2013 saw a prevalence of long-term liabilities to banks (58%), which since the onset of the crisis have increased by 9 percentage points owing to short-term liabilities to banks. This points to the fact that banks most probably replaced non-performing short-term loans with long-term loans in order to mitigate liquidity pressures on companies. The shares of financial liabilities to companies in the group and other financial liabilities remain relatively low despite their increase during the crisis (by 3 percentage points and 7 percentage points, respectively). Also important are operating liabilities that account for 38% of overall debt; with a dynamics similar to liabilities to banks. These liabilities fell by 9 percentage points in the observed period. Their fall was most probably due to lower demand in the time of the crisis. As regards operating liabilities, the largest share is recorded by accounts payable to suppliers (59% of operating liabilities). Their share remained constant throughout the analysed period and only varies by 2 percentage points.

The corporate sector has been improving its liquidity ever since the beginning of the crisis; a major shift was recorded in 2011 when current assets decreased less than current liabilities. During the crisis, the coefficient of absolute liquidity[23] rose by 2 percentage points, the coefficient of accelerated liquidity[24] by 6 percentage points, and the coefficient of overall liquidity[25] by 8 percentage points. The volume of current assets, and even more notably the volume of current liabilities, decreased between 2010 and 2012, but rose again in 2013. The highest growth was recorded by cash holdings and short-term financial investments.

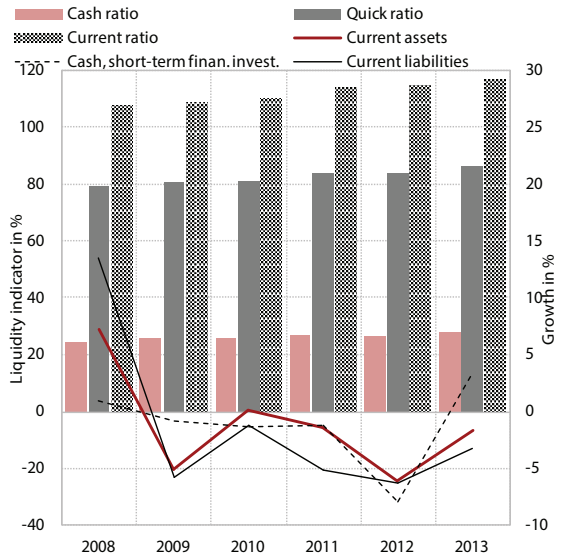
Table 1: **Structure of overall debt of common companies**

Liabilities of common companies (in EUR bn, in nominal terms)	2006	2007	2008	2009	2010	2011	2012	2013
Financial liabilities (1 + 2 + 3)	15.6	20.2	24.9	25.3	25.1	24.7	23.2	21.9
1. to banks (A + B)	11.6	15.3	18.0	18.0	18.0	17.1	15.2	14.2
A. long-term	5.8	7.2	8.1	8.8	9.2	9.2	8.6	8.2
B. current	5.8	8.0	9.9	9.2	8.8	7.9	6.6	6.0
2. to companies belonging to the group (A + B)	1.6	1.8	2.3	2.1	2.2	2.7	3.0	2.8
A. long-term	0.6	0.7	0.7	0.8	0.8	1.1	1.2	1.1
B. current	1.0	1.1	1.5	1.4	1.5	1.6	1.8	1.7
3. other liabilities	2.4	3.1	4.6	5.1	4.9	4.9	5.0	5.0
Operating liabilities (4 + 5 + 6)	16.1	19.5	19.7	18.7	17.2	16.6	15.8	15.4
4. accounts payable to suppliers (A + B)	9.3	10.9	11.2	10.6	10.5	9.8	9.5	9.1
A. long-term	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
B. current	9.0	10.7	11.0	10.4	10.4	9.7	9.4	8.9
5. to companies belonging to the group	1.7	2.0	2.1	2.1	2.2	2.1	1.9	2.0
A. long-term	0.1	0.1	0.1	0.1	0.0	0.1	0.2	0.2
B. current	1.6	2.0	2.1	2.0	2.1	2.0	1.8	1.9
6. other liabilities	5.2	6.6	6.3	6.1	4.6	4.8	4.3	4.3
Other liabilities	2.5	3.0	3.2	3.2	3.1	3.3	3.4	3.4
Total debt	34.2	42.8	47.8	47.2	45.5	44.7	42.3	40.7

Source: AJPES, calculations by IMAD.

[23] The cash ratio seeks to set a norm for the minimum necessary amount of money for the everyday repayment of debts due. Excessive liquidity could in fact be achieved through lower return on assets.
cash ratio = total cash and cash equivalents / current liabilities * 100)
[24] The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets.
quick ratio = current assets without inventories / current liabilities * 100
[25] The current ratio indicates whether a company could cover all current short-term liabilities with the available short-term assets.
current ratio = current assets / current liabilities* 100

Figure 19: **Coefficient of current, quick, cash and growth of current assets, current liabilities and "wider" cash of common companies in the private sector in 2008–2013**



Source: AJPES, calculations by IMAD.

3.3.3 Corporate investment activity

Considering that investments are crucial for economic growth and highly sensitive to a company's financial condition, they represent a key link between corporate indebtedness and/or deleveraging and economic growth. Based on the link between financial indicators and investment activity, we will attempt to establish whether Slovenian companies are financially constrained. We are interested, in particular, in the link between cash flow, indebtedness, cash holdings, interest payment burden and investments, depending on the size of the company[26]. The crisis revived the problem of information asymmetry on capital markets, resulting in a wedge being created between the cost of funds raised internally (retained earnings) and externally (by issuing equity or debt). This wedge (the "external finance premium") depends on the borrower's financial position and significantly influences the company's investment activity. Higher indebtedness or lower cash flow thus have a negative impact on a company's creditworthiness, increasing the external finance premium and reducing the demand for external financing.

The link between capital formation and financial indicators is particularly interesting when looked at from the viewpoint of the size of companies. According to theory, in fact, the external finance premium is negatively related to the size of the company, while financial indicators have a significant influence on the company's investment decisions. Small companies are often believed to have a higher risk of failure than large companies. Likewise, small firms are often young and have not had the time to build up a track record and reputation. Bank's costs involved in monitoring risk are often relatively high. All this suggests that small companies' credit sources tend to dry up more rapidly during economic downturns than those of large companies, thereby severely hampering small companies' investment. This aspect is particularly important for Slovenia where micro and small companies represent 60% of all existing companies, generate 33% of the total value added and employ 39% of the labour force.

The companies with a higher cash flow and higher cash holdings invest more. Companies with a high interest payment burden record lower investment rates, just like those with a high financial debt. Figures 20–21 indicate different corporate groupings and their investment ratios[27] Corporate groupings are formed based on individual financial indicators; the figures indicate the median investment ratios of such groupings. In order to reduce endogeneity problems, groupings are formed depending on the value of financial indicators in the transitional period[28].

[26] Based on the analysis prepared for companies in the euro area by ECB (ECB Occasional Paper 151: Corporate finance and economic activity in the euro area, by Task Force of the Monetary Policy Committee of the ESCB, August 2013). The focus is exclusively on companies in Slovenia. The database is different but nevertheless enables an analysis up to 2013.

[27] The investment ratio is defined as the change of tangible fixed assets plus depreciation divided by total assets. The data base to analyse investments is similar to the main data base of common companies, although it is more limited since quite often the main base does not feature all data relating to the investment ratio.

[28] See the above-mentioned ECB paper.

Figure 20: **Investment ratios by various financial indicators**

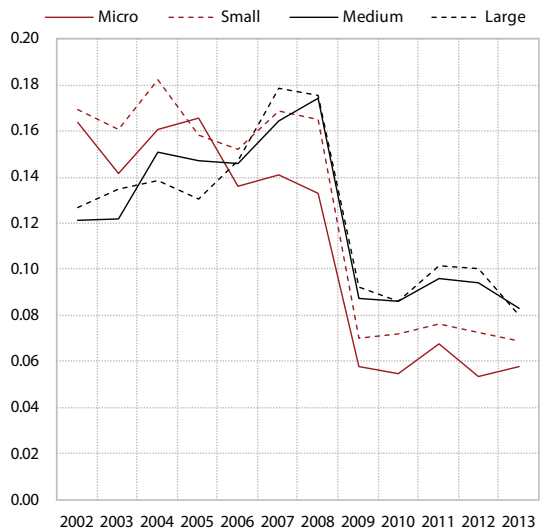
Source: AJPES, calculations by IMAD.
Note: The charts depict the median investment ratio of individual corporate groupings. Charts a) and b) present companies in the highest, lowest and medium decile (between the 45th and 55th percentile) in terms of cash flow and cash holdings. Chart c) indicates the grouping with no financial liabilities, low financial liabilities (under the 20th percentile in total liabilities) and high financial liabilities (above the 80th percentile). Chart d) features companies where interest exceeds EBITDA, the grouping where such indicator is between the 40th and 60th percentile, and the grouping where the indicator is below the 20th percentile.

The movements in the investment ratio of the grouping with medium cash flow and interest payment burden (chart 20) suggest that after 2009, the threshold above which the financial indicator becomes relevant for companies' investment decisions was lowered, i.e. that after that year financial constraints increased. Before 2009, the mean investment ratio in the above groupings was relatively similar to the one recorded by those companies with higher cash flow and high interest payment burden, while since 2009 it has been close to the grouping with low cash flow and low interest payment burden. Figure 20 also indicates a significant decline in investment activity in 2009.

According to data, the crisis puts more constraints on small companies. In 2009, investment activity decreased in all size classes (Figure 21), with the dynamics of decrease depending on the size of the company. Before 2009, the investment ratio of micro and small companies was often higher than the ratio of medium and large companies, while after that year the investment ratio of these two groups was constantly lower (Figure 21). The figures in Annex 1

indicate that the investment ratio of large and medium companies in all three groupings defined by cash flow (high, medium or low cash flow, upper decile, 45th to 55th percentile, and lower decile) fell slightly after the beginning of the crisis. The decline was even more pronounced in small and micro companies, yet those with the highest cash flow gradually enhanced their investment activity after 2009.

Figure 21: **Corporate investment ratio by size (median values)**



Source: AJPES, calculations by IMAD.

3.4 Over-indebted common companies

Over-indebtedness is an important indicator in the selection of measures to reduce debt in order to improve corporate performance and economic growth. Although decreasing ever since 2009, over-indebtedness was still relatively high in 2013 (EUR 10.2 bn). The relative burden of debt has a negative impact on companies as it hampers access to bank loans. Deleveraging was most intense in companies with the highest debt (financial debt was more than 10 times EBITDA).

In 2013, over-indebted companies generated about three quarters of bank and financial debt and more than half of the total debt of common companies, and accounted for a third of all companies and employees. They generated only 25.9% of value added and only 9% of total EBITDA. Over-indebted companies include companies with a financial debt that is five times higher than EBITDA as well as indebted companies with a negative EBITDA. A total of 32% of companies were over-indebted in 2013, and half of them had a negative EBITDA. Their number grew slightly in the first two crisis years but has remained stable ever since. The total number of over-indebted companies as a share of common

Table 2: **Principal characteristics of common companies by level of debt**

Common companies	2006	2007	2008	2009	2010	2011	2012	2013
Number of companies	32168.0	34225.0	36501.0	37561.0	38332.0	38144.0	36604.0	38209.0
Moderate financial liabilities	73.8%	73.8%	70.9%	65.0%	64.6%	65.3%	65.7%	67.5%
Over-indebtedness	26.2%	26.2%	29.1%	35.0%	35.4%	34.7%	34.3%	32.5%
Number of employees	467619.3	496137.3	507349.4	476574.1	458703.0	444828.5	431000.8	422460.2
Moderate financial liabilities	71.9%	70.5%	62.8%	55.7%	56.9%	62.0%	63.6%	66.8%
Over-indebtedness	28.1%	29.5%	37.2%	44.3%	43.1%	38.0%	36.4%	33.2%
Total debt (EUR bn)	34.2	42.8	47.8	47.2	45.5	44.7	42.3	40.7
Moderate financial liabilities	56.2%	50.7%	43.7%	35.9%	34.5%	38.1%	39.8%	42.2%
Over-indebtedness	43.8%	49.3%	56.3%	64.1%	65.5%	61.9%	60.2%	57.8%
Financial debt (EUR bn)	15.6	20.2	24.9	25.3	25.1	24.7	23.2	21.9
Moderate financial liabilities	37.5%	34.1%	29.0%	20.2%	20.9%	24.7%	26.3%	27.6%
Over-indebtedness	62.5%	65.9%	71.0%	79.8%	79.1%	75.3%	73.7%	72.4%
Bank debt (EUR bn)	11.6	15.3	18.0	18.0	18.0	17.1	15.2	14.2
Moderate financial liabilities	39.8%	35.3%	28.9%	20.7%	21.0%	24.8%	26.2%	27.1%
Over-indebtedness	60.2%	64.7%	71.1%	79.3%	79.0%	75.2%	72.9%	72.9%
Value added (EUR bn)	14.4	16.3	17.5	15.8	15.9	16.0	15.7	15.8
Moderate financial liabilities	79.7%	77.5%	70.3%	64.7%	64.6%	69.7%	71.0%	74.1%
Over-indebtedness	20.3%	22.5%	29.7%	35.3%	35.4%	30.3%	29.0%	25.9%
EBITDA (EUR bn)	5.1	6.0	6.1	4.8	4.8	5.0	4.9	4.9
Moderate financial liabilities	90.2%	87.5%	81.4%	80.6%	82.0%	83.8%	85.9%	91.0%
Over-indebtedness	9.8%	12.5%	18.6%	19.4%	18.0%	16.2%	14.1%	9.0%

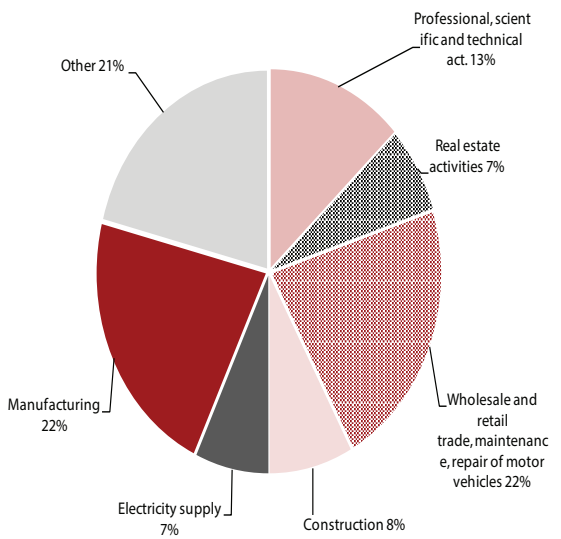
Source: AJPES, calculations by IMAD.

companies rose until 2010 but gradually shrank to reach a level that was lower than in the first crisis year. The number of employees followed a similar trend. In 2013, companies with a negative EBITDA employed 10.4% of the total workforce of common companies. The total debt of over-indebted companies rose most notably in the first year of the crisis and continued to increase until 2010, reaching nearly 66%; in 2012 and 2013, that share decreased and almost reached the pre-crisis levels. The dynamics in the share of financial and bank debt was similar: it peaked in 2010 but returned to pre-crisis levels in 2013. Thus, in 2013, over-indebted companies accounted for 72% of financial debt and 73% of bank debt.

3.4.1 Analysis of over-indebted companies by activity

In 2013, as much as 57% of the financial liabilities of over-indebted companies were concentrated in the sectors of wholesale and retail trade and repair of motor vehicles, in manufacturing, and in professional, scientific and technical activities. These three sectors account for as much as EUR 13 bn of financial debt. High shares (8% and 7%) are also recorded in construction, real estate, and electricity, gas and steam supply activities. With the exception of those last three, the shares are similar to those in the pre-crisis years. Electricity, gas and steam supply increased its share over the past three years mainly owing to one single company; the companies in this sector represent only 0.8% of all companies. Without that company, the over-indebtedness of this sector would be lower by three quarters. Most indebted companies are in the trade sector (24%) and in professional, scientific and technical activities (19%).

Figure 22: **Financial debt of over-indebted common companies by activity in 2013**



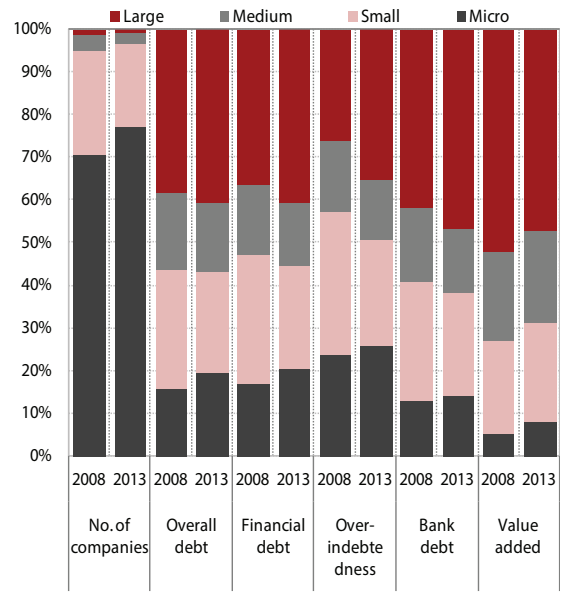
Source: AJPES, calculations by IMAD.

The most indebted (FL>5) are professional, scientific and technical activities and electricity, gas and steam supply. In the first activity, FL has been increasing ever since 2006 and totalled 18.3 in 2013; the recent increase was, however, much less pronounced than immediately after the onset of the crisis. This activity also presents the largest difference in the value of that indicator between over-indebted and less indebted (FL<5) companies, the latter recording a value below 1. This means that debt is concentrated in just a few companies that are heavily indebted, while other companies in the sector do not have major problems in this regard. According to the FL indicator, electricity, gas and steam supply presents a similar debt level, although this only holds true for the last year when FL value more than doubled. High indebtedness is recorded also by real estate activities where FL is 13.6, but the debt seems to shrink as the FL value fell by 3.3. Construction has a FL equal to 8.2, but that has been decreasing in the past two years and is already below the 2009 level. Among over-indebted companies with a negative EBITDA, the most indebted are construction and professional, scientific and technical activities. Among the less indebted (FL<5), the value of that indicator is the highest in manufacturing (1.4), yet it has been increasing since 2010 and nearly reached the 2009 level.

3.4.2 Analysis of over-indebted companies by size

Large companies represent a very small share of over-indebted companies (0.6%), but account for 41% of the total and financial debt and 47% of bank debt, and generate the largest share of value added (47%). A comparison of the situation today and before the crisis reveals that the share of large companies and the volume of value added generated thereby decreased, but their share in total, financial and bank debt rose. The majority of over-indebted companies are micro companies (77%), which however account for only a fifth of the overall and financial debt and generate 8% of value added of indebted companies. In the analysed period, micro companies increased their share in the number of companies as well as in added value and overall, financial and bank debt. The second highest share of debt was recorded in 2013 by small companies (19.8%) which contributed 23.9% to overall debt and a similar share to financial and bank debt, while generating 23.2% of value added. Medium-sized companies, whose share among over-indebted companies was only 2.5% in 2013, gradually decreased their overall, financial and bank debt, whereas their value added remained almost unchanged.

Figure 23: **Basic characteristics of over-indebted companies by size, as a share of all over-indebted companies**



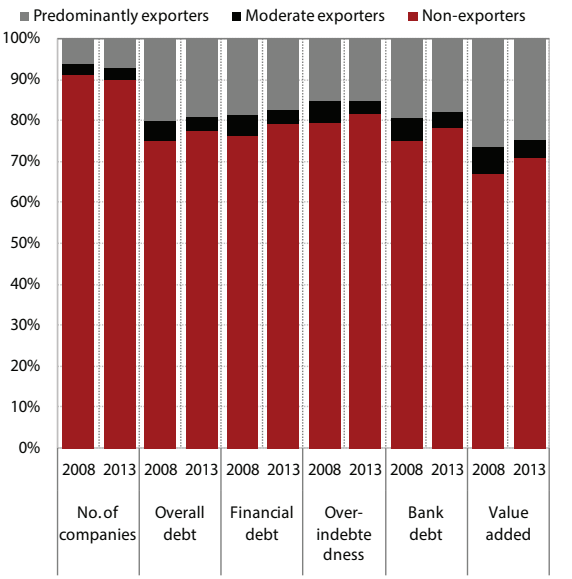
Source: AJPES, calculations by IMAD.

In terms of size[29] and financial debt relative to EBITDA, the highest debt among over-indebted companies[30] is recorded by micro companies, while the least indebted are medium-sized companies. Over-indebtedness of micro companies with a positive EBITDA and FL above 5 amounts to 14.8 and declined compared to 2011 and 2012 to the pre-crisis level. Small and large companies borrowed slightly less, with the indicator around 10.5. During the crisis, small companies constantly decreased their debt while large companies raised it. Medium companies whose debt is the lowest among over-indebted companies (9.5) also constantly reduced their debt. As regards indebted companies with a negative EBITDA, the most heavily indebted are again micro companies (-9.0), whose debt remains at the 2010 level, whereas the least indebted are large companies (-3.9) that have been deleveraging ever since 2010. The value of the indicator gradually declined for small companies (down to -4.5) but increased for medium companies (to -5.6). Less indebted companies (FV<5) present lower and more stable ratios over time; in all size groups, the indicator ranges between 1 and 1.5, which corresponds to the 2007 level. Contrary to the most indebted companies (FV>5), micro companies of the less indebted group have the lowest debt while medium companies have the highest debt. This again suggests that there is still a healthy core of companies operating normally.

3.4.3 Analysis of over-indebted companies by export orientation

In 2013, as much as 90% of over-indebted companies were focused on the domestic market. These companies account for nearly 80% of total, financial and bank debt and generate 71% of value added among over-indebted companies. Compared to 2008, their number remained almost unchanged while their total, financial and bank liabilities rose by 2 to 4 percentage points. The share of exporters[31] among over-indebted companies increased slightly (to 10%), while total, financial and bank liabilities were down by 3 percentage points, thus ranging between 23 and 21%. In 2013, exporters thus accounted for a good fifth of total, financial and bank debt of all over-indebted companies. Their value added fell by nearly 4 percentage points.

Figure 24: **Basic characteristics of over-indebted companies by export orientation**



Source: AJPES, calculations by IMAD.

[29] Micro companies are those with a headcount of up to five employees, small companies have six to 50, medium-sized companies 51 to 250 employees, and large companies more than 250 employees. In 2013, the database covers 61,312 companies, specifically 37.4% zero-employee companies, 46.9% micro companies, 13.6% small companies, 1.7% medium companies and 0.3% large companies. The total headcount was 425,833: 11.4% at micro companies, 27.4% at small companies, 25.4% at medium companies and 35.7% at large companies.

[30] Over-indebted companies have FL>5.

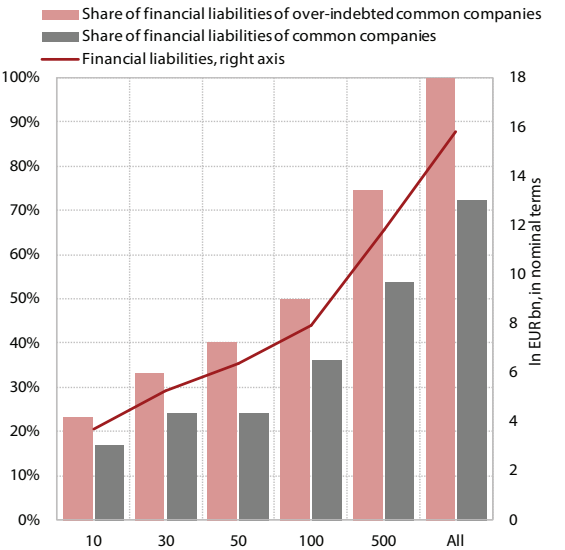
[31] Export-oriented companies are companies whose sales revenues on foreign markets exceed sales revenues on domestic markets. Companies with a medium or prevailing orientation on exports make up 10% of the total database and domestic market-oriented enterprises 74.6%; the latter account for roughly 65% of the total value added of all companies in the database. For some companies (15.4%) there are no data to measure their export orientation; their share in total value added is insignificant.

The analysis of indebtedness, as measured by the ratio of financial liabilities to EBITDA, by export orientation revealed[32] that companies focusing on the domestic market are more indebted than export-oriented companies. Since the crisis first hit export-oriented companies and only later affected those focusing on the domestic market, their share oscillated up until 2013. The debt of exporters decreased in 2010 but rose again in subsequent years to 9.1 for predominantly exporters and 9.8 for moderate exporters. This was mostly related to the pick-up on export markets. The decline in the indebtedness of exporters is a result of the considerable reduction in the volume of bank loans. Over-indebtedness of non-exporters rose ever since the onset of the crisis but decreased to the 2011 level (11.1) in 2013.

3.4.4 Concentration of debt in over-indebted companies

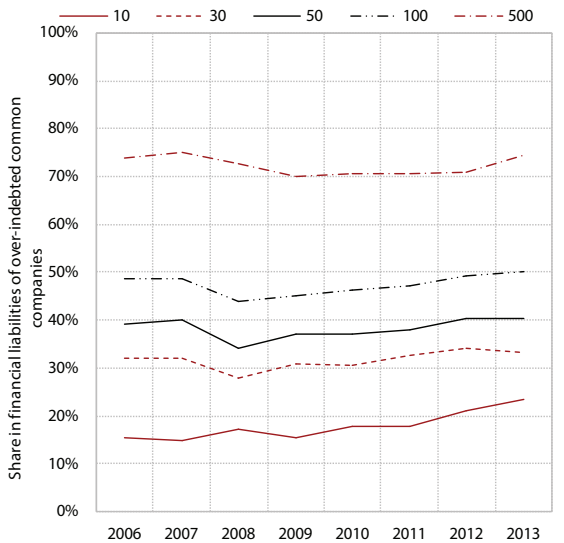
Ten of the most indebted common companies account for almost a quarter (EUR 4 bn) of financial and a fifth (EUR 5 bn) of the total debt of over-indebted companies. Thirty of the most indebted companies make up as much as one third of financial (EUR 5.3 bn) and total debt (EUR 7.1 bn). These companies have a headcount of nearly 30,000, which is 7% of total employment, and generate 4% of value added. The most indebted companies have an extremely high financial leverage and hardly pay their interest. Seventeen out of the 30 most indebted companies had been over-indebted even before the crisis, while 13% of them also have low interest coverage (IC< 1). Ten out of the 30 most indebted companies in 2013 are also among the 30 most indebted companies in the entire period under consideration.

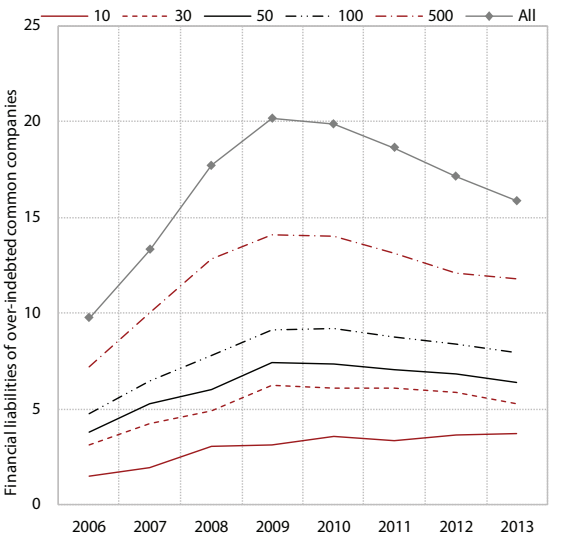
Figure 25: **Concentration of financial debt of over-indebted companies, 2013**



Source: AJPES, calculations by IMAD.

Figure 26: **Share of the most indebted companies in total financial debt of over-indebted companies**





Source: AJPES, calculations by IMAD.

[32] Export-oriented companies are companies with sales revenues on foreign markets exceeding sales revenues on the domestic market. 10% of companies in the total database for 2013 are to a medium extent and predominantly export oriented, while 74.6% of companies are oriented to the domestic market; the latter generate around 65% of value added of all companies. For some companies (15.4%), data on the calculation of export orientation are not available, but the share of these companies in value added is negligible.

4 Impact of deleveraging on economic growth and implications for economic policy

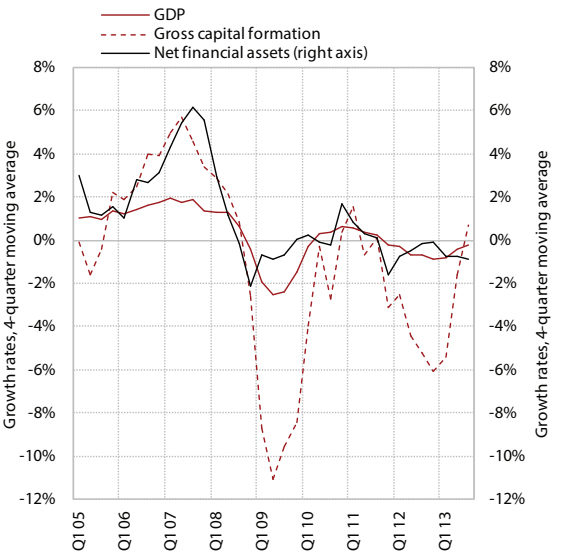
The first characteristic of the indebtedness of the Slovenian economy and the accompanying deleveraging process is the fact that the debt of non-financial corporations relative to GDP (Table 3) is close to the euro area average. The euro area also presents a considerable degree of heterogeneity as the PIIGS states record a much higher corporate indebtedness as a share of GDP than other countries. Slovenia is somewhere in-between. Compared to the stable euro area countries, Slovenian companies are over-indebted considering the value added they generate, but are still above the PIIGS average.

The second characteristic is that in terms of capital, the total debt of Slovenian non-financial corporations (Table 4) is one of the highest in the euro area. This suggests that in addition to excessive debt in absolute terms, an even more pressing problem is the inadequate financing structure i.e. inadequate ratio between debt and equity funding.

The third characteristic is the dynamics of debt growth. Figure 27 depicts 4-quarterly moving averages of GDP, capital formation and net debt growth of non-financial corporations. The analysed period can be roughly divided into three parts. 2005–2009 was a period of high growth of GDP and gross capital formation, and of high growth of net indebtedness of non-financial corporations. With the deterioration of conditions on international financial markets after the crisis had hit the US real estate market in 2007, a considerable cooling of the Slovenian economy began in 2008, reaching a peak in 2009 with the sharp decline in gross capital formation and GDP and the first wave of deleveraging. 2010 and 2011 saw a partial correction as economic decline slowed down and partly turned into growth. However, in 2012 the economic situation had already deteriorated again, resulting in a significant decrease of gross capital formation, a relatively moderate fall in GDP, and the start of the second and still ongoing wave of net deleveraging. Since the third quarter of 2011 (up until the third quarter of 2013), net debt of non-financial corporations has shrunk by roughly 5% in real terms, i.e. EUR 1.3 bn (in real terms, ref. year 2000). The above findings are confirmed by Table 3 presenting the average quarterly growth rates of the said variables.

The deleveraging of companies during the crisis is a natural consequence of the accumulated over-indebtedness before the crisis. The key question in this regard is, what was the impact of deleveraging on economic activity. Based on this, it can be assumed what the best course of that process will be in the future.

Figure 27: **GDP, GCF and NFA growth rates, 2005 Q1 – 2013 Q3, 4-quarterly moving averages, real prices (ref. year 2000)**



Source: Eurostat, ECB.
Note: positive NFA growth means higher net indebtedness while negative growth means net deleveraging.

Table 3: **GDP, GCF and NFA average growth rates, 2004 Q2 – 2013 Q3, real prices (ref. year 2000)**

	GDP	GCF	NFA
2004	0.9%	0.0%	3.2%
2005	1.4%	2.2%	1.6%
2006	1.7%	4.0%	3.2%
2007	1.4%	3.4%	5.6%
2008	-0.4%	-2.6%	-2.1%
2009	-1.5%	-8.4%	0.1%
2010	0.6%	0.4%	1.7%
2011	-0.2%	-3.1%	-1.6%
2012	-0.9%	-6.1%	-0.1%
2013	0.2%	4.0%	-1.2%

Source: Eurostat, ECB.

Box 1: **Assessing the impact of credit shocks by means of the vector autoregressive model with smooth transitions**

The methodological base for the empirical analysis of non-linear impacts of corporate deleveraging is the vector autoregressive model with smooth transitions (Auerbach & Gorodnichenko, 2012). The model is presented with relations (1) to (4) where Π_E (L) and Π_R (L) represent the polynomials of regression coefficients, separately for recession and expansion. The VAR model estimator is thus equal to the weighted average of estimators for both regimes, where the transition variable F(zt) represents the weight.

$$\mathbf{X}_t = (1 - F(z_{t-1}))\Pi_E(L)\mathbf{X}_{t-1} + F(z_{t-1})\Pi_R(L)\mathbf{X}_{t-1} + \mathbf{u}_t \quad (1)$$

$$\mathbf{u}_t \sim N(0, \Omega_t) \quad (2)$$

$$\Omega_t = \Omega_E(1 - F(t_{t-1}) + \Omega_R F(z_{t-1}) \quad (3)$$

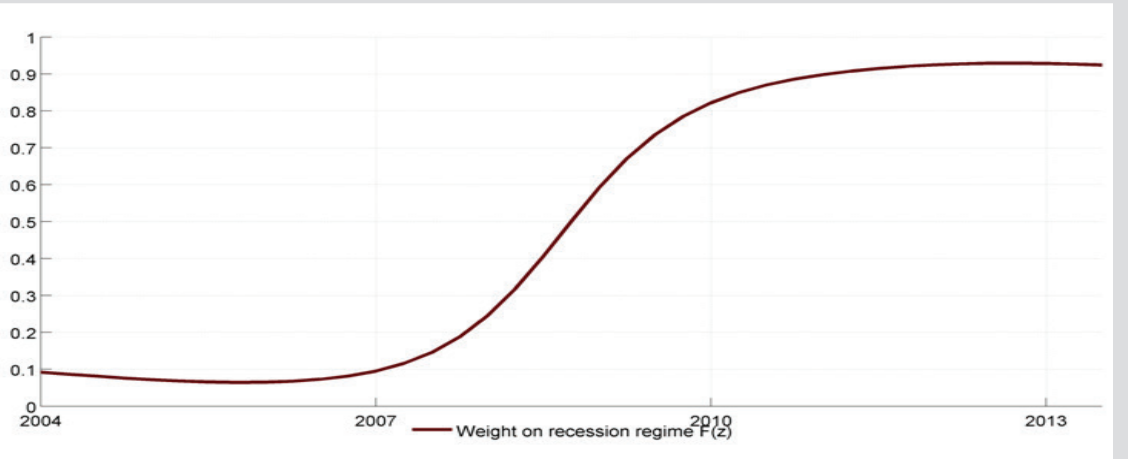
$$F(z_t) = \frac{\exp(-\gamma z_t)}{1 + \exp(-\gamma z_t)}, \ \gamma > 0 \quad (4)$$

The transition variable F(zt), allowing a switch between regimes, is determined in consideration of variable zt, which defines the state of the economy. The HP trend of quarterly economic growth rates was applied as a good indicator of this, and it allowed us to separate the sample in periods of high and low growth. As indicated by the following figure, the economy is in expansion when F(zt) is near 0 and in recession when F(zt) is near 1.

The endogenous variables vector of the Xt model is composed of gross domestic product, gross capital formation and net financial assets of companies, whereby all variables are defined at the quarterly level and in real values (ref. year 2000). The source of data is Eurostat and ECB. Net financial assets were deflated with the GDP deflator. All variables enter the model in the form of logarithms.

The parameters were assessed by means of the Bayesian simulation method (Markov chain Monte Carlo) on 100,000 simulations of the Metropolis-Hastings algorithm. The identification scheme for structural shocks is based on the Cholesky decomposition with the assumption of a hierarchical structure of simultaneous relations among endogenous variables. Corporate net financial assets are the last in turn, which means that they are considered the most endogenous variable of the system, which rapidly adjusts to other exogenous disturbances in the economy. Such assumption is reasonable because of the pre-determination of capital formation and the delays in the implementation of investment plans. At the same time, this means that positive exogenous disturbances in net financial assets can be interpreted as exogenous shocks of deleveraging.

Figure 28: **Transition variable F(z) values**

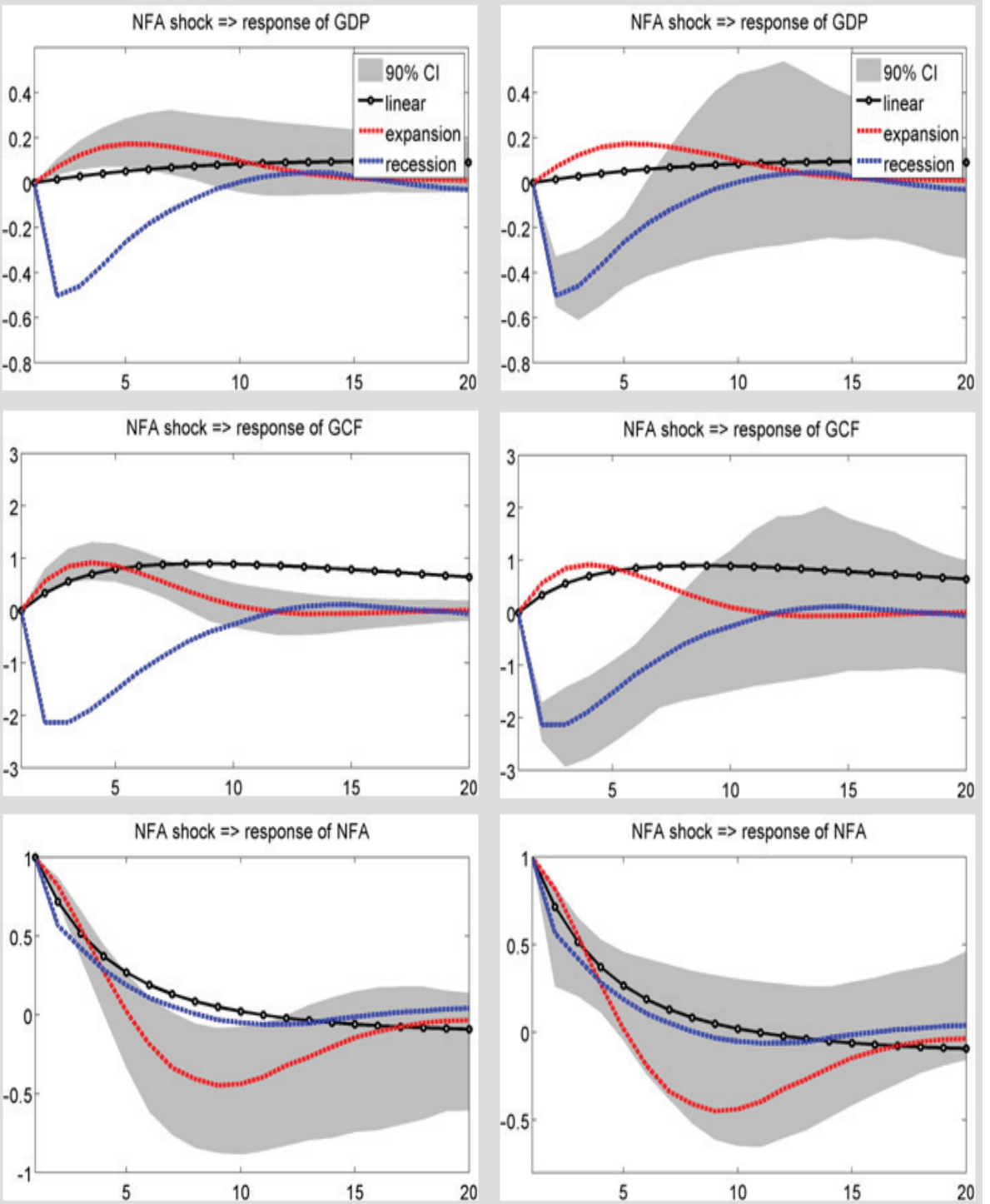


Source: calculations by IMAD.

The results of the above model confirm our initial hypothesis, since the impulse response functions for both regimes significantly differ. A positive response of capital formation and GDP to the exogenous positive shock in net financial assets – which can be interpreted as impact of lower loan supply – is characteristic of the period 2004–2008. That period was indeed marked by an extremely high growth of loans which, however, were poorly allocated and thus did not have

a positive effect on economic activity. During the recession (2009–2013), both variables responded differently. In fact, when net financial assets increase, i.e. when net debt falls, both variables notably and rapidly decrease, which leads to the conclusion that unexpected and exogenously induced deleveraging of non-financial corporations during recession has an extremely negative effect on the economy. In absolute terms, the response of both variables during recession is stronger and faster. For both variables, the strongest negative effect in recession is about twice the positive effect in expansion, whereas speed is assumed based on the result that the strongest effect in recession is achieved after six months while the lag in expansion takes one year. Results show that a 1% decline in net debt during recession reduced GDP on the half-year horizon by approximately 0.5%. The same effect is obtained with a reduction of capital formation of around 2%.

Figure 29: **Impulse response functions**



Source: SURS, Ministry of Labour, Family and Social Affairs; calculations by IMAD.

The impact of indebtedness of non-financial corporations on gross capital formation and GDP was analysed by means of structural vector autoregression with smooth transitions. This method enables us to separate the impacts of exogenous changes in debt by stage of business cycle, i.e. separately for recession and expansion periods. Such a distinction is *a priori* reasonable since data provided in Chart 2 allowed us to clearly identify the differences in the dynamics of net financial debt before and after the crisis. The method and key results are presented in Box 1.

In normal times, when companies are not constrained because of the situation in the banking sector, the increase in net financial assets (i.e. decline of net financial liabilities) should, all things being equal, serve as a basis to increase capital formation and thus the volume of operations of companies. It should be noted, however, that this involves an adjustment of net financial assets to the trend of financial deepening, where economic development increases money supply to GDP.

During recession, reverse effects are possible. An overall fall in demand and problems in the financial system enhance corporate financial constraints. In such conditions, a sudden rise in net financial assets i.e. reduction of financial liabilities (deleveraging) can be related to lower investment activity. The need of companies to deleverage in fact decreases their investment capacity since surplus liquid assets are spent on the repayment of debt and not on capital formation. During times of crisis, the decline in net corporate indebtedness is expectedly related to a fall in investment activity.

The results of empirical analysis presented in Box 1 confirm the initial suppositions. During recession (in the analysed period this corresponds to 2009–2013), exogenous increase in net financial assets and net deleveraging are followed by a decline in investment activity and GDP. Thus, unexpected and exogenously induced deleveraging of non-financial companies has a strong negative impact on economic activity. For both variables, the strongest negative effect in recession is about twice the positive effect in expansion. The impact is also faster since the strongest effect in recession is achieved after six months while the lag in expansion takes one year. Results show that a 1% decline in net debt during recession reduces GDP on the half-year horizon by approximately 0.5%. The same effect is obtained with a reduction of capital formation of around 2%.

With due consideration of the average growth in net financial assets in the last year for which data are available (2012 Q4 – 2013 Q3), which accounted for -0.9%, and with the assumption that the entire change can be interpreted as a structural shock, it may be established that in such period corporate deleveraging affected GDP by -0.2 to -0.5% and gross capital formation by -1% to -2%.

5 Challenges

The deleveraging of heavily indebted Slovenian companies has a negative influence on economic growth. International comparisons show that Slovenian companies have a higher debt relative to GDP than those in economically stable euro area countries. At the same time, they have very low shares of equity in total liabilities and hence excessive debt. Both data indicate the need to continue the deleveraging process which began during the financial crisis. However, the Slovenian economy is still in the phase of recession and, according to our econometric analysis, a rapid reduction in financial leverage has an adverse impact on investment activity and economic growth.

To minimise the negative short-term effects of deleveraging on economic activity, it is thus necessary to use deleveraging tools that are not focused primarily on direct loan repayment but that also provide additional equity. In a period when this is difficult to achieve through the capital market, this involves a more intensive use of the debt-for-equity swap mechanism or a partial write-off of debt, followed by privatisation, where the BAMC should play an active role.

Additional capital should be mainly obtained from private – both foreign and domestic – sources of finance, while the state's ownership role should be reduced and an ownership structure put in place that will facilitate corporate development and improve corporate governance. State ownership, which is still significant in the Slovenian economy, has not proved optimal in the past, in our assessment. Due to the ineffective management of state-owned companies in the past, state ownership mainly represents an additional pressure on public finance.

The provision of fresh capital on the market and the deepening of financial markets would also be facilitated by additional financial incentives for financial investors, such as additional tax allowances for pension funds, and promoting the importance of old-age saving. Improving the financial structure of enterprises will also involve ensuring the functioning of other segments of financial services that are mainly based on long-term sources of finance. A possible alternative could be provided by the instrument of securitisation that would allow larger and more financially stable enterprises to seek funding under more favourable conditions on other financial markets.

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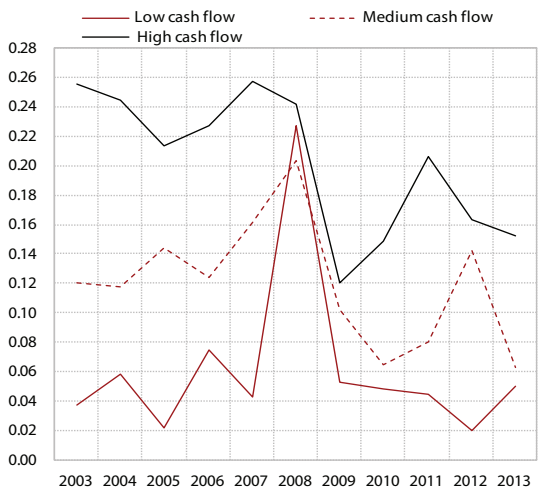
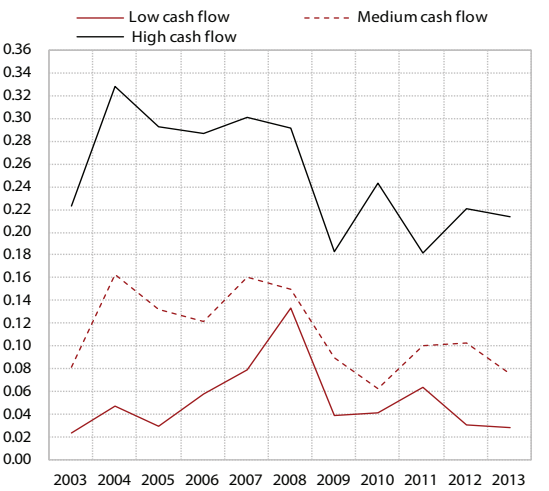
Appendix – Corporate investment activity

Figure 1: **Investment ratios by company size and with regard to cash flow (high, medium, low cash flow; upper decile, decile between 45th and 55th percentile and lower decile)**

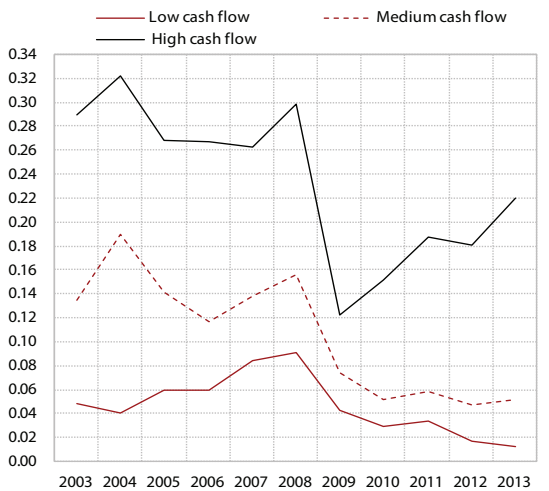
Large companies



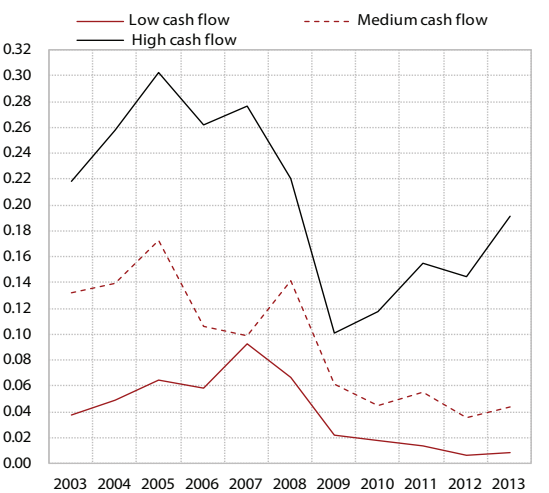
Medium-sized companies



Small companies



Micro companies



Source: AJPES, calculations by IMAD.

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