OECD Economic Surveys SLOVENIA

APRIL 2013

OVERVIEW

Summary

Main Findings

The economy is in a deep recession. Slovenia has been hit hard by a boom-bust cycle, compounded by reform backlogs and the euro area sovereign debt crisis. The reduction of public and private sector indebtedness is significantly weighing on growth amid tight financial conditions, growing unemployment and stalling export performance. Although important reforms have been adopted in 2012 and early 2013, additional and far-reaching reforms are needed as soon as possible to restore confidence and head off the risks of a prolonged downturn and constrained access to financial markets.

Slovenia is facing a severe banking crisis, driven by excessive risk taking, weak corporate governance of state-owned banks and insufficiently effective supervision tools. Major state-owned banks have been recapitalised several times. Additional capital needs are expected but their amount remains uncertain as the main results of earlier stress tests and due-diligence analysis have not been disclosed and their assumptions are most likely outdated. The creation of the Bank Asset Management Company to ring-fence impaired assets is welcome, but lack of transparency and potential political interference pose risks. The corporate sector has a severe debt overhang and some firms face insolvency, while existing insolvency procedures are long and result in low recovery rates. Limited equity markets and the backlog in the privatisation programme are hindering foreign direct investment, whose increase would help smooth corporate deleveraging. An agreement on a list of public assets to be privatised or managed by a new sovereign holding company is still lacking.

The authorities have adopted an ambitious fiscal consolidation path, but the fiscal position is not yet sustainable. The budget deficit rose significantly during the downturn and restoring public finances has proved difficult, despite marked progress in 2012, contributing to tensions in the sovereign bond market. With no policy changes, public debt could double to exceed 100% of GDP by 2025, including the expected costs of ageing and rescuing banks. A recent reform of the pension system is a welcome step forward, but bold additional reforms are needed to curtail upcoming ageing costs and stabilise the public debt since the last reform will stabilise pension expenditure up to 2020 only. To boost credibility, the authorities have adopted an ambitious fiscal consolidation path, which is commendable, but have so far relied too heavily on temporary steps, across-the-board cuts in the public wage bill and reductions in discretionary expenditure. In addition, some tax cuts partly offset consolidation efforts. The current fiscal framework seems insufficient to help combine an ambitious consolidation path with needed flexibility as the expenditure rule is not sufficiently binding and the fiscal council lacks sufficient technical expertise.

Restructuring welfare spending would help achieve fiscal sustainability. The performance of Slovenia in terms of expenditure control is poor: the increase in general government spending has been significantly higher than on average across the OECD since the outset of the crisis. While an increase in social spending is appropriate to cushion the impact of the deep recession, income inequality is already relatively low in Slovenia and there is room to restructure the welfare state without undermining the quality of public services. Despite recent progress in means testing of cash transfers following the introduction of a comprehensive electronic system, the eligibility criteria could be further tightened. Spending on health care is consistent with Slovenia's economic development level, but there is scope to rationalise its delivery in inpatient care. There is excess capacity in pre-school and compulsory education and the allocation of tertiary education services is regressive. Despite a recent cut in unemployment benefits, high average effective tax rates that are partly driven by generous social transfers hamper the transition of inactive and unemployed persons to the labour market.

Potential growth has fallen significantly since the outset of the crisis. As a result, Slovenia is unlikely to resume the catching up towards more developed OECD countries soon. In addition, the political economy of reform has been difficult, slowing the adoption of structural reforms. Competition in the product market is not vibrant enough – notably as state ownership is large and the Competition Authority has been lacking resources – to facilitate economic adjustment. The labour market is not sufficiently flexible although an improvement is expected following the adoption of a recent reform aimed to reduce significantly labour market dualism.

Key recommendations

Solving the banking crisis

- Conduct and disclose the main results of new top-down and bottom-up ("due-diligence") stress tests of the banking sector, which should be conducted under conservative and transparent assumptions.
- Recapitalise distressed but viable banks, preferably by issuing shares, and wind down non-viable banks. To reduce the fiscal costs of bank resolutions, holders of subordinated debt and lower-ranked hybrid capital instruments should absorb losses.
- Privatise state-owned banks and do not retain a blocking minority shareholding.
- Adopt a legal framework for out-of-court restructuring of distressed businesses, streamline in-court procedures and encourage firms to apply early for insolvency.

Strengthening fiscal sustainability

- Focus fiscal consolidation on permanent measures while letting automatic stabilisers operate.
- Continue to reduce high-income earners' eligibility for family benefits and strengthen means testing of education-related benefits.
- Continue to gradually cut the combined generosity of unemployment benefits, social assistance and other transfers for the unemployed and inactive persons to increase work incentives and strengthen fiscal sustainability.
- Raise pupil-teacher ratios in pre-primary and lower secondary education and class sizes in primary and lower secondary education to reduce costs. Introduce universal tuition fees along with means-tested grants and loans with income-contingent repayments to boost spending efficiency.
- Further rationalise the public health benefit basket and shift from inpatient to ambulatory care.
- Broaden the tax base of compulsory health insurance to working students and raise contribution rates for pensioners.
- Pursue pension reform by gradually raising the pension eligibility age and contributory periods, and eventually indexing them to life expectancy. Consider further cutting replacement rates by lowering effective accrual rates and calculating pension rights over lifetime contributions.
- Bolster the credibility of the expenditure rule by transparently setting its parameters, defining escape clauses and adopting a corrective mechanism for deviations from the rule.

Boosting potential growth through structural reforms

- As currently envisaged in Slovenia to ease the progress of economic reforms, tighten criteria to veto a law by referendum.
- Further reduce labour market dualism by phasing out the preferential treatment of student work.
- Reduce state ownership in the economy, ease the regulation of professional services and strengthen the Competition Protection Office.

Assessment and recommendations

The economy is in a deep recession

Stabilising the economy is a key policy challenge

Slovenia has entered a double-dip recession and faces growing unemployment and heightened financial market stress (Figure 1, Panels A, B and C). The pre-crisis boom, driven by easy access to external funding and excessive risk taking by banks and businesses, has led to a protracted bust, which is compounded by domestic structural weaknesses and the European debt crisis. Banks' and firms' balance sheets have been severely impaired and their necessary deleveraging is depressing growth, as credit is declining (Figure 1, Panel D). Key banks, which are mainly state-owned, have required repeated recapitalisations to meet the regulatory solvency ratio for Tier 1 capital at 9% and their market value has collapsed. Public debt has surged from 22% of gross domestic product (GDP) in 2008 to 47% of GDP in 2011 and is expected to rise significantly more in the short term, partly driven by the rising costs of rescuing banks.

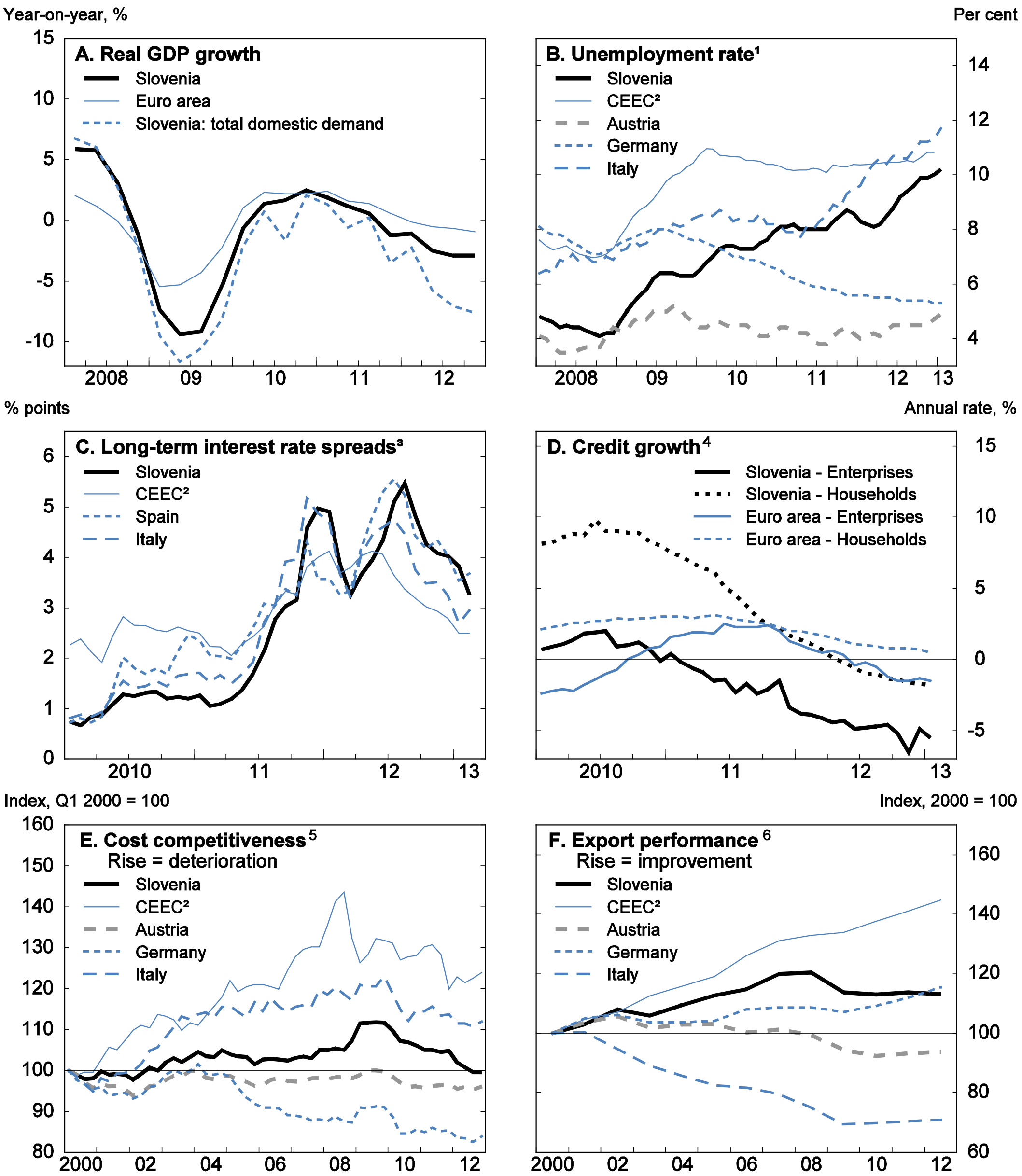
In this context, the government has engaged in an ambitious fiscal adjustment to cut the headline deficit from a peak of over 6% of GDP in 2011 to 2.5% in 2014. This adjustment, though necessary to restore confidence, will weigh on activity. Until recently, the difficulty of implementing overdue structural reforms, as seen in 2011 with some labour market changes and a pension system reform being rejected by referendum in 2011, has contributed to sovereign rating downgrades and reduced the prospect of boosting growth.

Against this difficult background and with a possible further deterioration in the international environment, Slovenia faces risks of a prolonged downturn and constrained access to financial markets. Additional and far reaching reforms are needed as soon as possible to head off such daunting outcomes. The recent adoption of pension and labour market reforms in December 2012 and March 2013 respectively are very positive steps in this regard. Also, the banking act has been amended and a law to ring-fence impaired assets in the banking sector has been adopted. However, uncertainties about the latter remain since important implementation decisions have still to be worked out. A comprehensive strategy is needed to sustain fiscal consolidation and restore the banking sector at the same time, but also to boost potential growth and competitiveness as well as reduce the reliance on external indebtedness, which exceeded 110% of GDP in gross terms in 2012. Such a strategy should be broad based, with product market reforms to heighten domestic competition and improve corporate governance and further policy changes in the labour market to foster economic adjustment and encourage labour participation (including through an additional reform of the pension system).

To make reforms happen, social and political consensus is needed. The political economy of reform remains difficult, notably because it has been easy to use a referendum to veto a law. The ongoing discussion in Slovenia on ways to introduce stricter criteria on the use of referendums is hence welcome. Options currently envisaged are to tighten the conditions for calling a referendum, to impose a minimum turnout, and to exclude some laws, such as tax and budget implementation laws.

The level of activity has fallen almost uninterruptedly since the third quarter of 2011, driven by the contraction in domestic demand. External demand has also weakened, in particular for more price-sensitive primary goods and low and medium-low technology products, which together represent almost 40% of Slovenia's merchandise exports. Market shares have been stagnant since mid-2009 (Figure 1, panel F), which contrasts with strong performance in Central and Eastern European Countries (CEEC). Hence, the narrowing of the current account deficit mainly reflects the collapse in domestic demand (Figure 1, Panel A).

Figure 1. Key macroeconomic developments



1. Labour force survey harmonised unemployment, seasonally adjusted data.
2. Unweighted average of Central and Eastern European Countries (Czech Republic, Hungary, Poland and Slovak Republic).
3. Ten-year government bond spreads relative to the German rate.
4. Loans adjusted for sales and securitisation. Enterprises = non-financial corporations.
5. Real effective exchange rates based on unit labour costs for the total economy.
6. Ratio between export volumes and export markets for total goods and services.

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* and *Main Economic Indicators* (databases), March; and ECB (2013), *Statistical Data Warehouse*, European Central Bank, March.

Cost competitiveness deteriorated somewhat in the 2000s, but the crisis has pushed down wage growth improving unit labour costs (Figure 1, Panel E). However, the margins of Slovenian exporters may have been insufficient to boost non-price competitiveness and gain market shares since the beginning of the crisis (Figure 1, Panel F). Following a 23% hike in 2010, the authorities should ensure that the minimum wage declines relative to the median wage over time and adopt a new social agreement introducing wage moderation over an extended period of time to support Slovenia's competitiveness. In the long term, greater foreign direct investment inflows and more efficient innovation policies would raise productivity and help climb the quality ladder (OECD, 2012a).

Manufacturing production has rebounded following its slump in 2008-09, but has failed to fully recover to pre-crisis levels. Construction activity has collapsed by more than 60% since its peak in 2008. With an impaired banking sector and shrinking bank balance sheets, credit conditions have been tight and lending to non-financial corporations and households has been declining (Figure 1, Panel D). The share of investment in GDP has dropped by nearly ten percentage points to below 20%, reducing capital stock accumulation and potential output growth, which is now estimated by the OECD to be only around 0.5-1% in 2013-14. The labour force survey measure of unemployment has increased from slightly below 4.5% in mid-2008 to close to 10% (Figure 1, Panel B). This has been coupled with labour force withdrawals, particularly among youth. At the same time, the share of long-term unemployment has risen to more than 50%.

Overall, the prospects for the economy are weak (Table 1) and worse than in many other OECD countries, with annual GDP set to contract significantly in 2013. Gross fixed investment is projected to continue to fall as a result of significant excess capacity, deep ongoing adjustment in residential construction, and contraction in credit driven by banks' deleveraging and the need to reduce corporate sector's debt overhang. This is despite government's efforts to increase the absorption of European Union (EU) funds and boost investments through tax reliefs and cuts in the corporate income tax rate. Private consumption is expected to contract further as a result of fiscal consolidation and growing unemployment. Important downside risks are related to the external side as Slovenia's exports amount to around 70% of GDP and are mainly oriented to the euro area countries. However, domestic factors are even more important, notably due to the possibility of a longer than expected deleveraging. The government successfully tapped the debt market in United States (US) dollars in October 2012 against commitment to deliver on structural reforms, but failure to do so owing to recent political uncertainties could significantly raise borrowing costs. Higher than expected bank recapitalisation needs could also trigger widening spreads. On the upside, a reduction of market concerns on the euro area debt crisis would support recovery.

The crisis has lowered potential output and medium and long-term growth prospects are weak in the absence of more ambitious policy changes, with average growth projected at 1.8% per year between 2011 and 2060 (Johansson et al., 2012). Economic activity will be held back by population ageing, which will reduce labour force participation, though education and productivity gains should be important engines of growth. The latter should be supported through broad product market reforms, which would also have positive spillovers on the labour market. Ambitious structural reforms would boost living standards in the long run by around 20% relative to the baseline scenario of moderate policy improvements.

Table 1. Recent trends and outlook

Percentage change, volume

	Outcomes					Projections[1]	
	Average 2003-08	2009	2010	2011	2012	2013	2014
Real gross domestic product	4.6	-7.8	1.2	0.6	-2.3	-2.1	1.1
Private consumption	3.3	0.1	1.3	0.9	-2.9	-4.0	-0.7
Government consumption	3.3	2.5	1.5	-1.2	-1.6	-7.5	-3.2
Gross fixed investment	7.7	-23.2	-13.8	-8.1	-9.3	-2.7	0.7
of which: Residential construction	9.5	-20.5	-20.4	-8.3	-16.3	-2.6	1.1
Stockbuilding[2]	0.5	-4.1	1.9	0.7	-1.9	-0.5	0.0
Total domestic demand	4.9	-10.0	-0.3	-0.6	-5.7	-5.1	-1.0
Exports of goods and services	9.4	-16.7	10.1	7.0	0.3	2.7	4.1
Imports of goods and services	9.9	-19.5	7.9	5.2	-4.3	-0.8	1.7
Net exports[2]	-0.3	2.4	1.5	1.3	3.3	2.6	2.0
Memorandum items							
Harmonised index of consumer prices	3.9	0.9	2.1	2.1	2.8	2.3	1.8
Unemployment rate (%)	5.8	5.8	7.2	8.2	9.0	9.7	9.8
Total employment	1.5	-1.5	-1.5	-3.1	-1.3	-2.9	-0.5
Labour productivity	3.4	-6.2	3.5	2.2	-1.1	0.8	1.6
Current account balance[3]	-3.1	-0.7	-0.6	0.0	2.5	5.1	6.4
General government financial balance[3,4]	-1.6	-6.0	-5.7	-6.4	-4.3	-3.6	-3.0
Gross debt (Maastricht definition)[3,4]	25.5	35.0	38.6	46.9	53.9	58.5	61.0
Household gross saving ratio (% of disposable income)[4]	16.0	14.9	13.5	11.9	11.5	12.6	13.4
Output gap (% of potential GDP)	2.8	-1.3	-0.8	-0.6	-3.3	-5.8	-5.5
Potential output	2.9	1.4	0.7	0.4	0.4	0.5	0.8

1. Projections published in the *OECD Economic Outlook* of December 2012. They do not incorporate a worsening of the public finances linked to the creation of the Bank Asset Management Company and recapitalisation of banks in 2013 and 2014.
2. Contribution to GDP volume growth.
3. Per cent of GDP.
4. Projections for 2012 also.

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), March and OECD (2012), *OECD Economic Outlook*, Vol. 2012/2.

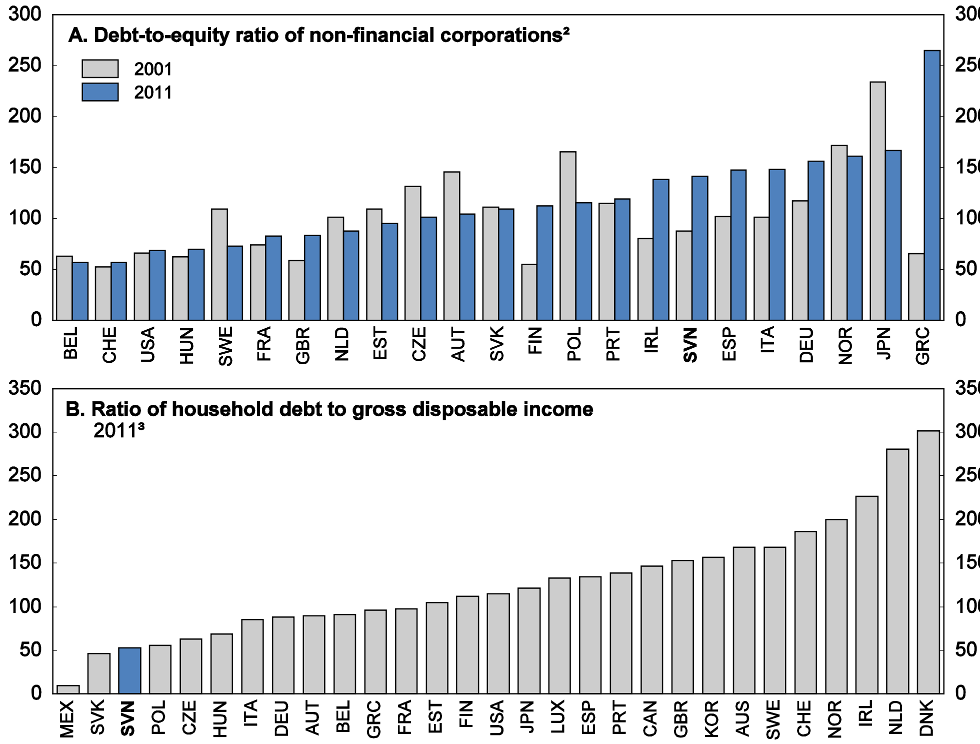
Restoring the banking sector is the most urgent priority

A boom-bust credit cycle has led to large corporate sector leverage and a high level of impaired loans

The loan-to-GDP ratio of Slovenian banks more than doubled from around 40% of GDP in 2003 to 92% in 2011. This increase reflected a combination of low interest rates and a massive inflow of foreign funding before the crisis, which boosted the loan-to-deposit ratio to 136% in October 2012, following a peak at 160% of GDP in 2008. Although the current level of the debt-to-GDP ratio of Slovenian non-financial corporations, at close to 141% in 2011 (the latest data available), is now only slightly above the OECD average, there are a number of risks that point to its unsustainability. The leverage of the nonfinancial corporate sector is high. Debt-to-equity stood at 143% in 2011 (Figure 2, Panel A), with the construction and real estate sectors being the most indebted as their debt-to-equity ratios exceed 315%.

Figure 2. Debt of non-financial corporations and households[1]

Per cent



1. Debt is calculated as the sum of the following liability categories, whenever available/applicable: currency and deposits, securities other than shares (except financial derivatives), loans, insurance technical reserves and other accounts payable.
2. Debt as a percentage of shares and other equity. This indicator measures the financial leverage or the extent to which activities are financed out of their own funds. Data for 2010 instead of 2011 for Estonia, Japan and Switzerland.
3. 2010 for Australia, Canada, Estonia, Japan, Poland and Switzerland; 2009 for Luxembourg and Mexico.

Source: OECD (2013), "OECD Financial Dashboard", *OECD National Accounts Statistics* (database), March.

Another risk is related to weak corporate governance in the context of extensive public ownership, notably in the banking sector (about 40% of banking loans are issued by state-owned banks and more banks are state-controlled). A weak framework for the governance of state-owned banks (SOBs) in Slovenia (OECD, 2011a) is likely to have contributed to poor credit standards, excessive risk taking by banks and misallocation of credit. Excessively favourable credit conditions have underpinned unsustainable mergers and acquisitions, management buy-outs or buy-outs of public shares at high market values (Damijan, 2012). Moreover, preliminary findings of the Slovenian Corruption Prevention Commission have recently pointed to widespread credit misallocation, likely related to corrupt behaviour. The dominance of state ownership appears to have undermined the quality of banking supervision by the Bank of Slovenia, which did not take sufficient steps to prevent large and connected exposures.

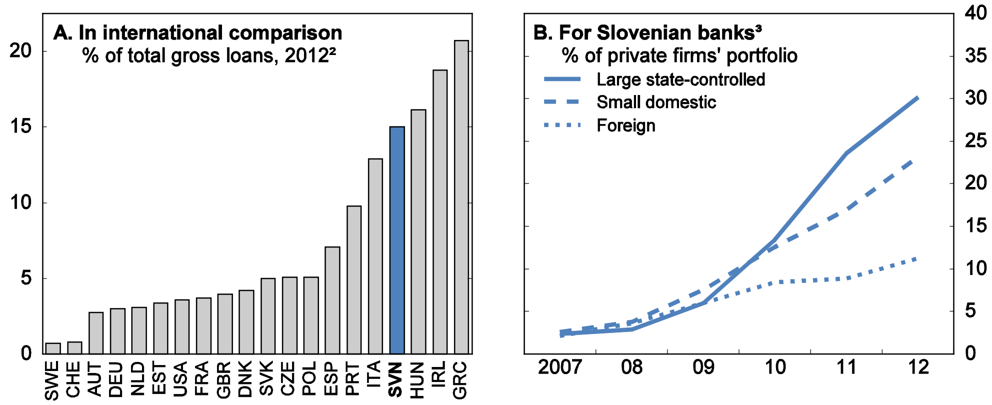
Anecdotal evidence also indicates mismanagement of the SOBs. As an example of credit misallocation, the two largest SOBs – Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) – extended loans amounting to, respectively, 20% and 15% of their capital to Zvon Ena, a financial holding company, which is currently under bankruptcy procedures. These two banks have also been heavily exposed to major construction companies. They appear to be among the least efficient in Slovenia, particularly on a profit basis, as discussed in the chapter on foreign investment, governance and economic performance of the 2011 *Economic Survey* of Slovenia (OECD, 2011b). There have been frequent changes in the composition of management and supervisory boards of these banks and several chief executive officers have cited political interference as one of the reasons for their decision to resign.

By contrast, household indebtedness is low (Figure 2, Panel B). Despite house price overheating in some parts of the country, relatively prudent lending in general (loan-to-value ratios peaked at around 60% in 2007) has protected households from a major deterioration of their balance sheets. Nevertheless, a further deterioration of the labour market combined with further falls in housing prices and euro depreciation could eventually change the picture. Indeed, real estate prices fell so far by 12% between end 2007 and the third quarter of 2012 and 17% of housing loans are denominated in Swiss francs as of December 2012.

The unwinding of the boom has led to a high proportion of non-performing loans (NPLs), defined as all classified claims in arrears over 90 days, that jumped to 14% of banks' loan portfolios (19% of GDP or about EUR 7 billion) in October 2012, one of the highest ratios in the OECD (Figure 3, Panel A). As the recession drags on, this is likely to deteriorate further. The situation is particularly worrying in the non-financial corporate sector, where NPLs reached 24% of the portfolio. Construction companies are responsible for a large share, as 62% of their loans are overdue for more than 90 days and the largest companies are insolvent. The quality of the loan portfolio has deteriorated the most for large state-controlled banks, whose NPLs to private firms amount to 30% of their total loans to these firms in October 2012 (Figure 3, Panel B). In comparison, foreign banks in Slovenia have a NPL ratio of only 11% of their lending to private firms, suggesting that an increase in bad loans of state-controlled banks reflects not just the business cycle but also deeper governance problems.

Figure 3. Non-performing loans are high[1]

Share of non-performing loans, per cent



1. Overdue or non-performing loans (claims in the case of Slovenia) are loans with failed payment obligations for at least 90 days.
2. Latest quarter based on available bank balance sheet data; third quarter of 2012 for the majority of countries shown.
3. For 2012 the data provided is for October. The category "large state-controlled" covers banks where the state holds, either directly or indirectly, a blocking minority shareholding. It covers the following: NLB, NKBM, Abanka, Banka Celje, SID banka and Gorenjska banka. Based on the latest data available, the share of each category of banks in terms of loans is 58% for large state-controlled, 8% for small domestic and 34% for foreign banks.

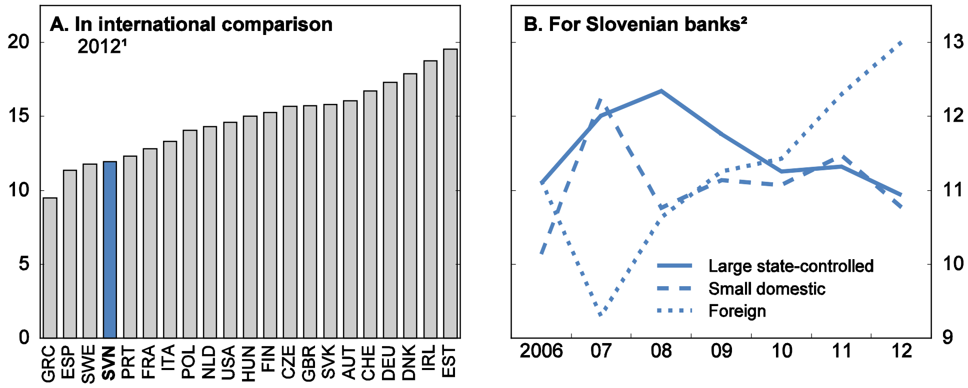
Source: IMF (2013), *Financial Soundness Indicators*, International Monetary Fund, March, *http://fsi.imf.org* and Bank of Slovenia.

Most banks remain fragile and there is a need for a comprehensive resolution framework

The crisis has put pressures on the solvency of Slovenian banks. Despite several injections of public funds into SOBs to fulfil supervisory requirements, Slovenian banks remain poorly capitalised in international comparison (Figure 4). Moreover, capital adequacy ratios will probably decline when all bad loans are recognised and some of them need to be written off. The authorities evaluate recapitalisation needs at up to 3% of GDP (EUR 1 billion). Yet, capital needs are uncertain and could in fact be significantly higher. While the central bank has performed stress tests (a top-down exercise based on macroeconomic scenarios) and a single consultancy firm has performed a due-diligence analysis (a bottom-up exercise with a loan-by-loan analysis) of major banks, the main results have never been made public. This is in contrast to practice in other countries facing severe banking difficulties, such as recently in the United States and Spain. In addition, the underlying assumptions of due-diligence analysis were not conservative enough and are, therefore, most likely already outdated.

Figure 4. Capital adequacy ratios

Total regulatory capital as a per cent of risk-weighted assets



1. Latest quarter based on available bank balance sheet data; third quarter of 2012 for the majority of countries shown.
2. For 2012 the data provided is for September. The category "large state-controlled" covers banks where the state holds, either directly or indirectly, a blocking minority shareholding. It covers the following: NLB, NKBM, Abanka, Banka Celje, SID banka and Gorenjska banka. Based on the latest data available, the share of each category of banks in terms of loans is 58% for large state-controlled, 8% for small domestic and 34% for foreign banks.

Source: IMF (2013), *Financial Soundness Indicators*, International Monetary Fund, March, *http://fsi.imf.org* and Bank of Slovenia.

Based on market valuation, most state-owned bank equity has been virtually wiped out. As of 26 December 2012, the market value of NKBM and Abanka, the second and the third largest banks, stood at 12% and 13% of their book value. Even though such values have declined in all countries, the average ratio stands at 170% in Latin America, 140% in Eastern Europe and 80% in developed markets (McKinsey, 2012). The shares of NLB, the largest bank, are not traded on the stock exchange, but at the end of December 2012 the government bought a 22% share from the Belgian KBC for only 1% of its book value. Such low market valuations of bank equity are an indication of potentially large capital shortfalls. As mentioned above, the amount of loans in arrears over 90 days is significant (about one fifth of GDP) and if such loans were to be fully written off, they would most likely result in large bank capital shortfalls.

In this context, repairing bank balance sheets and ensuring the recapitalisation of viable banks are one of the important elements for stabilising the economy and, in particular, for a resumption of bank lending. Moreover, there is a risk that banks have incentives to "evergreen" bad loans (roll them over to avoid recognising losses on their books) and "gamble for resurrection" (by issuing high-risk high-return loans). According to best practice, resolution procedures should involve independent due-diligence of the whole banking sector to divide banks into four groups: *i*) solvent institutions; *ii*) viable banks that are currently distressed but can solve their problems without intervention; *iii*) viable banks that are currently distressed and require intervention; and *iv*) non-viable banks that need to be closed in an orderly way. Such classification of banks was used in Spain and Sweden, and is supported by the Bank of Slovenia.

To maintain market discipline, a well designed restructuring of the banking sector should ensure that unviable banks undergo orderly resolution. Given the absence of a specific bank bankruptcy law in Slovenia, the Bank Asset Management Company (BAMC), created in October 2012, could be one element of the bank resolution framework. It is to take over non-performing assets in return for government-guaranteed bonds of up to 11% of GDP (EUR 4 billion). In this way, the remaining cleaned-up banks could focus on normal banking operations, while the BAMC would specialise in the recovery of bad assets. Such a division of labour may be needed as banks appear to be unable or unwilling to deal with their bad loans; the average monthly ratio of written-off loans to overdue loans was only 0.2% in the first nine months of 2012, and at that rate banks would require about 40 years to clean up their loan portfolios. However, banks accelerated the cleaning up of their portfolio at the end of 2012. Finally, better access to capital markets and a greater chance to privatise repaired banks would be additional advantages.

The choice and pricing of non-performing assets and the subsequent identification of the resulting equity gap are key. The authorities prefer a tailor-made approach. However, best practice suggests that banks should transfer either all or none of the assets to the "bad bank" in a given category. Moreover, to motivate banks to be transparent, the transfer of assets should be a one-off opportunity to get rid of bad assets. Current law states that transferred claims have to be priced according to their "real long-term economic value". To determine a credible discount rate for the ring-fenced assets, international best practice is that due-diligence analysis be performed. As mentioned above, this was done, but did not include several independent reputable auditors and the results were not made public. To foster the credibility of the BAMC, a new bottom-up due diligence exercise based on conservative assumptions should be performed, accompanied by a top-down stress test by the central bank. The main results and underlying assumptions of both should be made public. For viable banks, capital should be raised as needed, preferably by issuing shares to the private sector, while non-viable banks should be wound down as soon as possible.

Improving resolution mechanisms is an important element of the international agenda of financial market reform to reduce the need for taxpayer revenues to bail out failing banks. This would help reduce the negative feedback loops between government finances and the financial systems (Financial Stability Board, 2011). The NLB and the NKBM have bought their hybrid capital instruments at a discount of 40-50% on a bilateral basis, but holders of subordinated debt should also absorb losses of banks that are resolved or are recapitalised by the government. The amount of subordinate debt is not negligible: about 3% of total banking assets. Fiscal costs could be reduced further by imposing losses on senior debt, in addition to subordinated debt, for banks put into resolution. It is important to stress that bail-in may increase the funding costs of Slovenian banks perceived as being at risk of becoming non-viable in the future, which would deter potential investors. Hence, it is important to carefully design the bail-in strategy to reduce this risk (IMF, 2012a).

To be robust, the corporate governance of the BAMC has to be backed by strong independence and accountability. The current law could set the stage for independent management because it foresees a public call for applications and the possibility of competitive salaries to attract reputable managers. Some managers have already been appointed. A potential weakness is that non-executive directors of the management board and members of an inter-ministerial committee, who will assess the business strategy of banks, do not have to fulfil any professional requirements. The BAMC is going to be financed by guaranteed debt with almost no equity. This will reduce the immediate impact on the budget deficit and will delay the effect of possible losses, but can create poor incentives for managers and deter private investors interested in buying BAMC bonds. To increase its financial independence, the BAMC should be capitalised, preferably with the participation of private investors. Finally, if the five year mandate appears to be too short to dispose all assets in good conditions, notably to minimise taxpayer costs, the mandate of the BAMC could be extended. Extending the mandate of the BAMC would be preferable to the option currently envisaged of transferring any remaining assets to the sovereign holding fund, which should be scrapped, since the BAMC should have a better financial expertise to value and dispose of these legacy assets.

Once the SOBs are cleaned up, they should be privatised to strengthen corporate governance and the stability of the banking sector. The Slovenian authorities have announced plans to reduce the public share in the two largest banks, which is welcome, but the decision to retain a blocking minority shareholding (and, thereby, control) should be dropped. International experience shows that partial privatisation can thwart true restructuring and lead to additional recapitalisation needs (Andrews, 2010). Moreover, the decision to keep a controlling stake, especially if remaining shares are widely held, opens the door to potential political interference, which could deter foreign investors and make the disposal of assets less profitable for the taxpayer. Unsuccessful experiences with the privatisation of the NLB and NKMB, including failure to follow through on commitments to significantly divest these assets, suggests the difficulties that may accompany this process now.

Deleveraging banks and the corporate sector

International experience suggests that crises preceded by credit booms tend to be followed by sizeable deleveraging (Tang and Upper, 2010). The loan-to-deposit ratio of Slovenian banks is around 136% (October 2012), against 105% in the euro area in the third quarter of 2012. While deleveraging will inevitably hurt growth, it is a necessary process to both reduce risks that over-indebtedness poses to the economy and lay the foundations for a sound recovery. The issue is not to slow down or impede this process, but to mitigate the negative impact on activity by restructuring viable enterprises and liquidating unviable ones. In the corporate sector, reduction in debt has started but it has so far mainly been driven by a decline in lending.

Out-of-court restructuring of non-performing loans could lead to more effective deleveraging. However, it should be regulated either by a set of guidelines or by a law, in line with the INSOL principles (International Association of Restructuring, Insolvency and Bankruptcy Professionals). In-court insolvency procedures are unattractive to debtors and creditors because they are geared to liquidations rather than to enterprise restructuring or a second chance to start a new business. Although there are procedures that aim at enterprise restructuring, similar to "Chapter 11" in the United States, there is little awareness of their existence and high compliance costs deter small and medium enterprises (SMEs). Only 26 cases were resolved this way in Slovenia in 2011. Hence, it is important to introduce fast-track simplified procedures for SMEs.

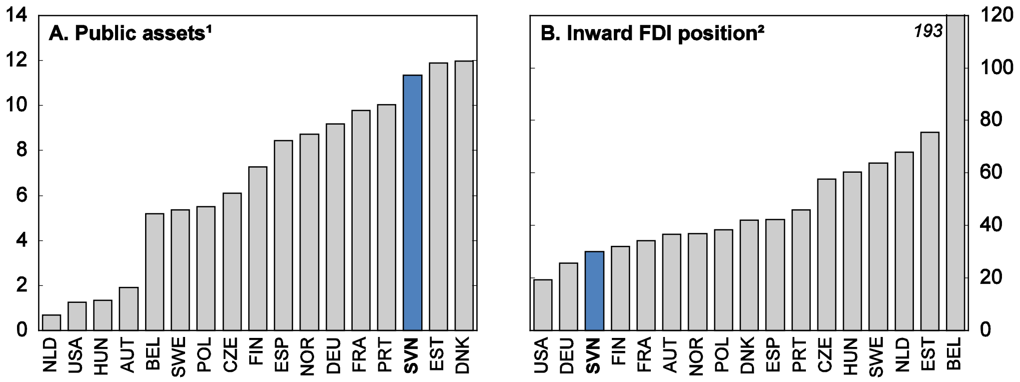
Long in-court insolvency procedures in Slovenia reduce recovery rates. According to the World Bank 2012 *Doing Business* indicators, it takes on average 24 months in Slovenia to complete a standard bankruptcy procedure (involving a main secured creditor and several unsecured ones). By contrast, it is possible to do this in less than one year in a number of OECD countries, including Belgium, Canada, Finland, Ireland, Japan or Norway. The appointment of judges who specialise in bankruptcy procedures and the set-up of a computerised case management system are welcome steps, but ensuring adequate staffing of courts could also be needed according to the 2012 *Index of Economic Freedom*.

Another reason why the recovery rate is low is because insolvency procedures are initiated too late, usually when it is impossible to save the enterprise. This is why it is important that the existing law on the financial liability of debtors who fail to announce their insolvency be enforced. It should apply not only to liquidity-insolvent companies, but also to balance sheet insolvent ones (when liabilities exceed assets), even if they are still able to meet their obligations. To motivate entrepreneurs to apply early, the insolvency procedures should distinguish between honest and fraudulent cases, with the former getting a fresh start (European Commission, 2011).

Deleveraging should also be achieved by raising equity, including by attracting foreign capital. More foreign investment would also strengthen corporate governance. Foreign direct investment has been low and public ownership remains high in Slovenia (Figure 5). The scope of the stock market to finance the economy is limited by the high degree of state ownership in the ten largest listed companies and weak protection of minority shareholders. Privatisation supported by the definition of a clear asset management strategy, better disclosure of related-party transactions to enhance investor protection and further strengthening of operational and financial independence of the Securities Market Agency would all bolster financial deepening and improve overall market discipline.

Figure 5. Public ownership is large and foreign direct investment is low

Per cent of GDP, 2011



1. As represented by "other equity" from the consolidated financial accounts of the general government sector. This covers financial equity assets and excludes quoted and unquoted shares in companies and mutual fund shares. Data is only available for a limited number of OECD countries.
2. The inward foreign direct investment (FDI) position relates to the stock of investments by non-resident investors in the reporting country at the end of the year. For comparison purposes, the same countries are shown as in panel A.

Source: OECD (2013), *OECD National Accounts Statistics* and *International Direct Investment Statistics* (databases), March.

Enhancing bank supervision

Although banking regulation follows international standards and banking supervision – under the authority of the Bank of Slovenia – is consistent with EU banking directives and many guidelines from the European Banking Authority, there have been weaknesses in the implementation of these standards (IMF, 2012a). Hence, it is important to strengthen banking regulation and supervision within the framework of the EU banking union. New amendments to the Banking Act adopted in December 2012 entrust the Bank of Slovenia with additional resolution powers, which is welcome. However, the law does not allow the Bank of Slovenia to implement a bail-in (impose losses on bond holders) and create bridge banks (a temporary bank to administer assets and liabilities of a failed bank). The root of the crisis is poor credit management by banks and the supervision appears retrospectively to have been insufficient to control the high concentration of risk in the construction sector and financial holdings. Although the supervisor has been requiring banks to strengthen their credit risk management, it has not yet been successful in obtaining significant improvements (IMF, 2012a).

The provisioning in Slovenia is done in accordance with International Accounting Standards, which gives the banks the discretion to apply different provisioning methods that are not always comparable. Given banks' poor risk practices in the past, they should instead be required to apply a homogeneous methodology for provisioning. The Bank of Slovenia should develop on-site examinations of loan portfolios on larger samples and induce banks to take a more conservative stance on collateral valuations (IMF, 2012b).

Taking into account the difficulty of improving banks' risk practices and corporate governance, the Bank of Slovenia should be more conservative and proactive in its provisioning requirements and ensure that other remedial actions are taken in a timely manner. Given the small size of the Slovenian economy and tight interlinkages between banks and firms, it has to be particularly prudent with provisioning requirements for large and related exposures.

As Slovenian firms borrow simultaneously from multiple banks, the absence of credit information sharing between banks could have been one of the reasons for poor risk outcomes. The Bank of Slovenia has a credit registry with positive information (loan conditions and repayment) and negative information (non-repayment of loans) and it should be required to share a complete set of information with banks. This will alleviate informational asymmetries between banks and borrowers and, thus, improve the quality and sustainability of financial intermediation (Brown et al., 2009). Finally, the Bank of Slovenia has to be more transparent and provide more up-to-date information on its webpage to improve market discipline and confidence.

Box 1. Core recommendations to shore up the banking sector

- Conduct and disclose the main results of new top-down and bottom-up ("due-diligence") stress tests of the banking sector, which should be conducted under conservative and transparent assumptions.
- Strengthen the Bank Asset Management Company (BAMC) by providing it with its own capital and ensuring that all directors and members of the inter-ministerial committee fulfil professional requirements.
- Recapitalise distressed but viable banks, preferably by issuing shares, and wind down non-viable banks. To reduce the fiscal costs of bank resolutions, holders of subordinated debt and lower-ranked hybrid capital instruments should absorb losses.
- Privatise state-owned banks and do not retain a blocking minority shareholding.
- Adopt a legal framework for out-of-court restructuring of distressed businesses, streamline in-court procedures and encourage firms to apply early for insolvency.
- Require the Bank of Slovenia to share a complete set of information from its credit registry with banks.

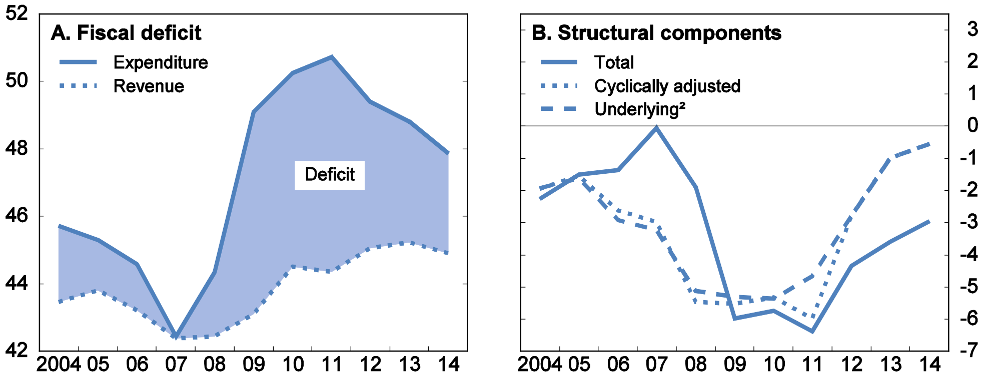
Restoring public finances

Fiscal consolidation has been difficult

The budget deficit rose significantly during the downturn (Figure 6, Panel A) and gross public debt reached 47% of GDP in 2011, up from only about 20% at the outset of the global crisis. The debt ratio may rise to around 72% of GDP in 2013, when considering the official maximum estimation of debt issuance of the BAMC to take over impaired loans (11% of GDP) and the cost of equity injections in banks of 3% of GDP. Long-term fiscal sustainability is weak and gross public debt is projected to reach 87% of GDP in 2025 in a no-policy-change scenario (European Commission, 2012a) and could exceed 100% of GDP by 2025 when including the already anticipated costs of rescuing banks. The materialisation of a number of risks could push the public debt even more in the short term: if growth turns out to be weaker than expected; if banks' recapitalisation exceeds official estimates; or if some contingent liabilities are recognised (IMF, 2012b), such as a possible reclassification of the debt of the national highway company (DARS) into general government, which would increase public debt by about 8-9% of GDP. Moreover, Slovenia faces a significant rise in total age-related public expenditure (which includes pensions, health and long-term care) by about 10 percentage points of GDP over the years 2010-60, against around 3 percentage points of GDP for the EU average (European Commission, 2012b). While the recent pension reform has been a step in the right direction, the expenditure on pensions is still expected to increase by 5 to 6 percentage points of GDP between 2020 and 2060 (see below).

Figure 6. Fiscal deficit and its structural components

General government, per cent of GDP or potential GDP[1]



1. Projections from 2012 onwards. These projections do not incorporate a worsening of the public finances linked to the creation of the Bank Asset Management Company and recapitalisation of banks in 2013 and 2014
2. Cyclically adjusted less one-offs.

Source: OECD (2013), *OECD Economic Outlook: Statistics and Projections* (database), March.

In this context, stabilising the debt ratio is a priority, which would reduce tensions in the sovereign bond market. If implemented fully, the current fiscal consolidation programme (Box 2) is a positive first step as it is expected to significantly reduce the underlying deficit to about 0.5% by 2014 (Figure 6, Panel B). If sustained, this would allow the headline deficit to eventually return to close to balance. Around this consolidation path, the government should let automatic stabilisers operate if growth turns out lower than expected and focus on consolidation measures that are the least detrimental on growth.

Improving the quality of fiscal consolidation

While the consolidation path is ambitious, policy decisions have relied too heavily on temporary measures, across-the-board cuts in the public wage bill and reductions in discretionary expenditure, including on tertiary education (see Box 2). On the spending side, more durable savings could be made by rationalising welfare expenditure (see below). Many SOEs other than SOBs are also unprofitable, in particular in the transport sector (railway and airline companies), and require regular bailouts. Any further recapitalisations of SOEs should go in tandem with a hardening of their budget constraints through the adoption of well-defined restructuring programmes. Reorganising local governments by reversing the trend of municipal fragmentation could also help to rationalise public expenditure (OECD, 2011c).

Certain measures on the revenue side should be reviewed also. The authorities have started lowering the corporate income tax rate by one percentage point per year, from 20% in 2011 to 15% by 2015. While such cuts would support investment in the medium term, subdued demand and evidence of excess capacity suggest that they may fail to revive growth in the short term. To ensure needed fiscal consolidation, further cuts should be delayed or the authorities should ensure that they are offset fully by other measures. Generous research and development (R&D) and investment tax allowances have also been adopted to boost growth. They apply to the level of R&D spending, not its increment, which may induce deadweight costs for expenditure that would have been made anyway. Public grants might be more cost-efficient and more effective in generating new spending, though they may imply winner-picking and are already well developed in Slovenia (OECD, 2012a).

Beyond the adoption of an exceptional recurrent tax on high-value immovable property not used for business activities, a structural overhaul and hike in such taxes for all properties, as planned in 2011, would also be a step in the right direction. Indeed, recurrent taxes on residential property are among the least damaging to growth (Arnold et al., 2011; European Commission, 2012b), but are low in Slovenia.

Box 2. Fiscal consolidation programmes since 2010

In 2010 and 2011, the government's objective was to pursue expenditure-based fiscal consolidation through a combination of temporary ("emergency") measures (cuts in public investment, consumption and subsidies) and permanent measures (to contain public-sector wage growth and indexation of pensions and other social transfers). Yet plans to reduce public sector employment did not go through and, instead, the headcount expanded further. Moreover, the minimum income used as a base for social assistance was hiked by almost 13% in January 2012.

Following early elections in December 2011 the new government embarked on a front-loaded and mainly expenditure-driven consolidation. The initial aim was to reduce the headline deficit to 3.5% of GDP in 2012, 2.5% of GDP in 2013 and 1.5% of GDP in 2014. The generosity of social transfers was reduced. Subsidies for school and student meals were lowered, parents were required to cover 30% of childcare costs for the second child, the parental benefit for child care and nursing was cut, the indexation of child benefits was frozen and eligibility conditions were tightened for higher-income earners. However, cuts in nominal public sector wages were 5%, somewhat less than what had been announced initially due to earlier commitments to increase wages. Measures on the revenue side include, among others, a new tax on immovable property, a new higher marginal personal income tax, and increased taxes on motor vehicles. Some measures have, nevertheless, a fixed expiry date (e.g. freeze on promotions or performance bonuses), are conditional (e.g. lower parental allowance for child care until the year after the year in which real GDP growth exceeds 2.5%), or both (e.g. a temporary increase in the standard value-added tax rate).

Additional consolidation steps have been penciled in the two-year budget to reach revised deficit targets of 2.8% and 2.5% of GDP for 2013 and 2014. Measures include, on the spending side, additional cuts in the wage bill by 5%, a reduced indexation of pensions, and a permanent cut of unemployment benefits. The pension reform legislated in late 2012 (see below) should also contribute to fiscal consolidation starting from 2013. Measures to boost revenues include higher excise duties on energy, tobacco and alcohol consumption, and higher tax burdens on banks.

Strengthening the fiscal framework

The fiscal framework is weak and may contribute to poor investor confidence. As discussed in the 2011 *Economic Survey*, significant duties and responsibilities were attributed to a fiscal council set up in 2009 (OECD, 2011b). However, the fiscal council does not have its own staff to perform fiscal surveillance and focuses too strongly on *ex post* evaluations of past fiscal developments rather than on prospective analyses of the fiscal position and upcoming budgets. There have been plans to strengthen its role to allow for an explicit *ex ante* assessment of draft budgets, but this proposal vanished in parliament. As recommended in the 2011 *Survey*, progress has been made with the use of the macroeconomic forecasts of a government think-thank – the Institute of Macroeconomic Analysis and Development (IMAD) – as a basis for the preparation of draft budgets. Going forward allowing IMAD, which regularly assesses fiscal policy and has a strong technical expertise, to take over the role of the fiscal council could strengthen the fiscal framework. IMAD should then provide timely evaluations of policy measures, with its budget directly determined by parliament to bolster its independence.

Slovenia has to follow the requirements set up in the European Union Treaty for Stability, Convergence and Governance which requires a path towards a balanced structural budget. The government plan to introduce a balanced budget rule in the Constitution has not been realised. Nevertheless, the authorities should improve the fiscal rule adopted in mid-2009. The rule links public expenditure to potential output growth and includes a correction for deviations of public debt and budget deficits from targets. Yet it has been insufficiently used to guide fiscal policy as its parameters have been frequently revised

(Court of Audit, 2012; European Commission, 2012c). The 2011 *Economic Survey* identified ways to improve the rule and reinforce its credibility (OECD, 2011b). In particular, the fiscal targets and the parameters underlying the convergence speed to these targets should be made more transparent. The rule should be supported by well-defined escape clauses and the fiscal council should be charged with assessing the rationale for their use. The rule could also be complemented by an adjustment account, similar to the Swiss debt brake rule.

Restructuring welfare spending

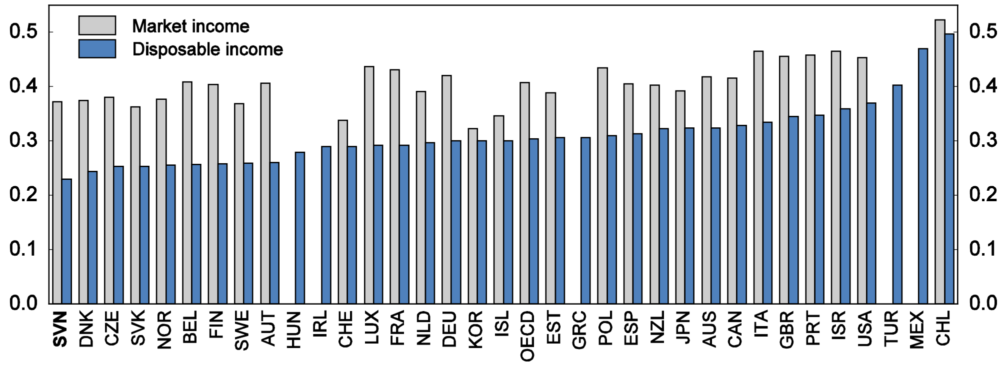
Public expenditure as a share of GDP is close to 50% in Slovenia and is now the highest among countries with similar levels of economic development, which suggests there is scope for an expenditure-based fiscal consolidation. Beyond the measures discussed above, restructuring welfare spending on social transfers, education, health care and public administration would help to tackle the budget deficit and improve fiscal sustainability. The level of social spending as a share of GDP is high, at almost 20% against around 17% for the OECD and other CEEC and 18% for the Nordic countries. Between 2007 and 2011, spending on social benefits and transfers in kind increased markedly by 3.5 percentage points of GDP while the corresponding increases were 1.5 percentage points for other CEEC, 1.9 percentage points for the Nordic countries and 2.2 percentage points for the OECD. At the same time, the increase in the compensation of employees by 2.2 percentage points of GDP was the highest in the OECD. This looser control of expenditure is only partly explained by more subdued GDP growth as increases in spending per capita were also sizeable. Despite recent progress, there is scope to close efficiency gaps in various areas of welfare spending and to better target social transfers without inducing excessive trade-offs with work incentives and equity objectives. Beyond fiscal consolidation, this would also expand the elbow room to amend the structure of expenditure in favour of growth-enhancing measures such as productive public investment or spending on active labour market policies (ALMPs).

Slovenia ensures one of the largest redistributions in the OECD, but revisiting the welfare state would not necessarily strongly increase the dispersion of incomes. First, Slovenia has the lowest OECD income inequality after tax and transfers (Figure 7), indicating some room for manoeuvre in reducing the size of redistributive policies without leading to an unequal society. In fact, income inequality is relatively low even before redistributive policies. As shown in Figure 7 Slovenia has a low dispersion of market incomes (before taxes and transfers) of the working-age population. Second, even if the Slovenian tax system is effective in reducing inequality by OECD standards and most of the redistribution occurs on the spending side, the progressivity of cash transfers is relatively low (Joumard et al., 2012). Cash transfers are equivalent to 67% of market income of the poorest 20% in Slovenia, which is comparable to the OECD average, but they are equivalent to 10% of high-income earners' market income (and essentially correspond to family benefits), which is high in comparison with other OECD countries (OECD, 2011d).

Better means testing would reduce the share of high-income earners eligible for cash transfers and boost fiscal savings. This would blunt work incentives because of correspondingly higher marginal effective tax rates when benefits are withdrawn, but empirical evidence suggests that the labour supply of high-income earners could remain unaffected at the hour-work margin (Meghir and Phillips, 2010). Moreover, additional savings could be reaped by means testing education-related allowances (transportation, student meals in tertiary education) and introducing stricter eligibility criteria (accommodation subsidies, state scholarships). Important progress has been made in this direction more recently with the implementation, since January 2012, of a new electronic system with a central database that allows more efficient income and wealth means testing of a wide range of social transfers and subsidies. Preliminary results indicate that the system is effective and has lowered eligibility of high-income earners to social transfers through tighter means testing and reduced fraud through better access to information.

Figure 7. Gini coefficients of inequality of market and disposable incomes[1]

Persons of working age (18-65 years-old), late 2000s[2]



1. Market income includes incomes from wages and salaries, self-employment income and cash property income together with occupational and private pensions. Disposable income is obtained by subtracting income tax and employees' social security contributions from gross income. Both income measures are adjusted to reflect differences in household needs depending on the number of persons in the household.
2. Late 2000s refers to a year between 2006 and 2009. The OECD average excludes Greece, Hungary, Ireland, Mexico and Turkey (no information on market income available).

Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*.

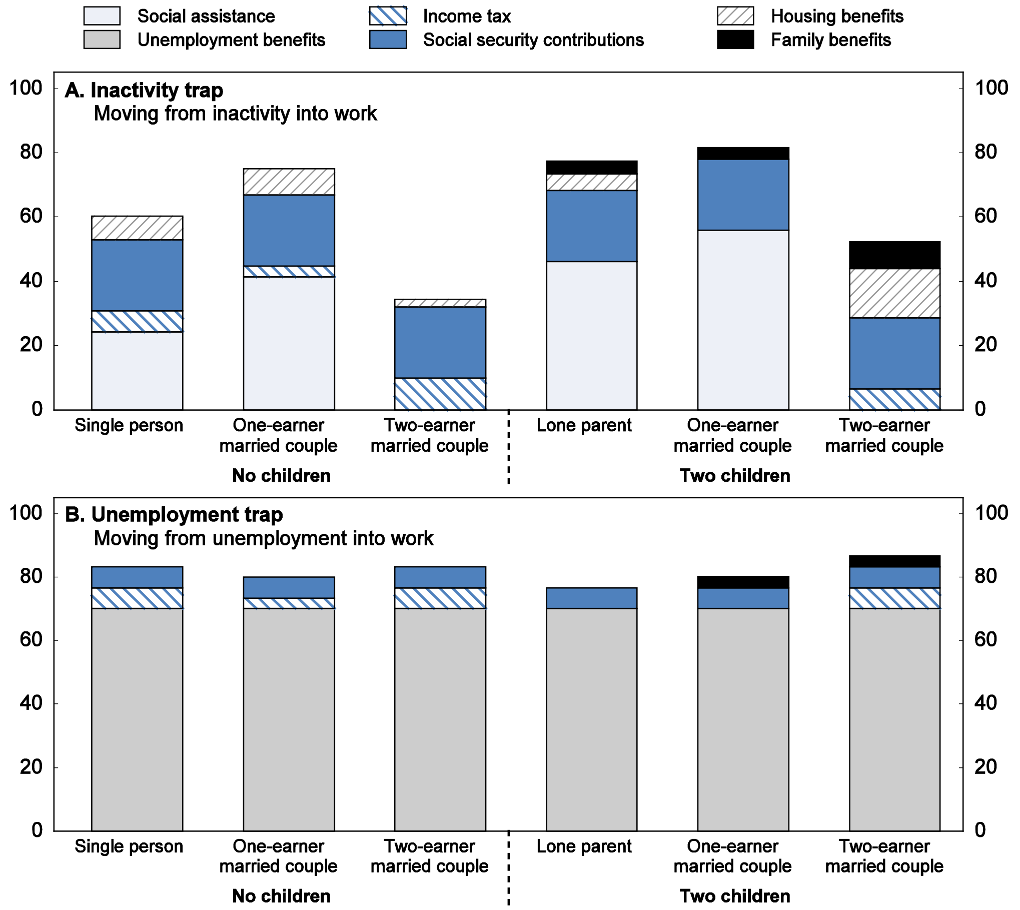
How to read this figure: The Gini coefficient has a range from zero (when everybody has identical incomes) to one (when all income goes to only one person). Increasing values of the Gini coefficient thus indicate higher inequality in the distribution of income.

Despite recent progress, there is still scope to reduce public spending by cutting the combined generosity of unemployment benefits, social assistance and other social transfers for the unemployed and inactive persons. This would boost work incentives and even more so if benefits could be withdrawn at a lower rate than the increase in earnings to allow a net increase in income. However, as such benefit reforms would worsen income distribution they should preferably be continued gradually. Indeed, empirical research shows that they can have more favourable employment effects in good times rather in bad times (Bouis et al., 2012). With this as a background, average effective tax rates when returning to work from unemployment and inactivity are high in Slovenia (Figure 8). This is true across all income levels and not only for people at the bottom of income distribution. Net replacement rates for the initial and long-term phase of unemployment are also high and recent fiscal consolidation measures have somewhat reduced the unemployment benefit ratios. Indeed, the replacement rate was cut from 60% to 50% for unemployment spells longer than a year. Also, the ceiling for the highest benefit amount was lowered by 15%. Finally, the duration of unemployment benefits of up to 25 months is relatively generous and could be shortened.

In-kind benefits contribute to diminishing income inequality in Slovenia (OECD, 2011d). In particular, the income-increasing effect of early childhood education and care services is large for families with young children and social housing is highly targeted to the poorest individuals. However, the allocation of tertiary education services could be better targeted. It is currently very regressive, as 35% of tertiary education expenditure goes to the top quintile of the income distribution and only 9% to the lowest one. The experience of OECD countries shows that introducing universal tuition fees along with means-tested grants and loans with income-contingent repayments would promote savings and equity while sharing the costs of higher education between the state and students (OECD, 2012b).

Figure 8. Inactivity and unemployment traps are large

Average effective tax rates, per cent, 2010[1]



1. Earnings from full-time employment of the individual moving into work are based on 67% of the average worker (AW) level. For married couples the percentage of AW relates to one spouse only; the second spouse is assumed to be inactive with no earnings in a one-earner couple and to have full-time earnings equal to 67% of AW in a two-earner couple. Calculations for families with children assume two children aged 4 and 6, neither childcare benefits nor childcare costs are considered. Any benefits received are subject to relevant income conditions or means-testing. For details of coverage, see the "Work incentives" section at *www.oecd.org/els/benefitsandwagesstatistics.htm*.

Source: OECD (2012), Tax/Benefit models (see *www.oecd.org/els/social/workincentives*).

How to read this figure: The bars show average effective tax rates, which indicate the amount of income that is lost due to taxes and reduced benefits as different types of household move from inactivity or unemployment into work.

There is also room to tackle spending inefficiencies in the provision of in-kind services. The calculation of efficiency frontiers reveals significant potential to either strengthen output efficiency (achieve better outcomes for the same level of expenditure) or input efficiency (reduce spending for the same outcomes) (Hribernik and Kierzenkowski, 2013). Slovenia ranks about 25th among OECD countries in terms of output efficiency and 18th to 27th in terms of input efficiency for the three areas of secondary education, health care and public administration.

Despite relatively good educational outcomes and the education system's capacity to equip the labour force with relevant skills, there is some scope to obtain a more efficient use of public resources, as discussed in the education chapter of the 2011 *Economic Survey* (OECD, 2011b). Increasing pupil-teacher ratios in early childhood and lower secondary education and class sizes in primary and lower secondary education could lead to a merger of some schools and school districts in cities as well as linking schools into clusters. Overall, this would allow a more effective use of staff, but could also increase population density in some areas. The authorities considered increasing teaching obligations and setting up unified school districts along with the adoption of a floor for the minimum number of pupils in a classroom. This could have led to lower costs due to a merger of some school districts and, as a result, more homogenous distribution of pupils among schools and higher class occupancy rates. Yet, the reform proposals have met with strong opposition from teachers' trade unions and the planned reorganisation steps have been suspended of late.

Reforming the financing of health care

Life expectancy at birth stood at 79.5 years in 2010, very near the OECD average, and total health expenditure is consistent with Slovenia's economic development level. The supply of health professionals (practising doctors, nurses and midwives per capita) is relatively limited in Slovenia and the allocation of resources is skewed to more costly specialist care (OECD, 2011e). While the cost effectiveness of generalist-provided primary care is widely recognised, general practitioners (GPs) are close to 20% of total doctors in Slovenia and are outnumbered by specialists with a share of above 70% (other doctors account for the remaining); the corresponding shares are around 25% for GPs and 58% for specialists in the OECD.

An increase in the supply of primary-care doctors would allow more extensive gatekeeping and cost-effective prevention in the medium term, though this strategy could boost spending in the short term. Easing the criteria allowing foreign doctors to practice in Slovenia might be one option. In 2011, a shortening of lengthy procedures of recognition of foreign diplomas by about two years was a step in the right direction. Other constraints, such as specialty examinations, compulsory internships and, for non-EU candidates, language requirements, would need to be relaxed as well. Reforming the payment system of GPs by introducing an element of pay-for-performance in the current mixed system of capitation and fee-for-service, would ensure attractive salaries for best performing doctors and provide incentives for a better use of existing capacity. This would encourage expenditure reallocation away from higher levels of care in the medium term.

A third of overall healthcare spending is on inpatient care and there is scope to improve efficiency in the utilisation of resources allocated to the hospital sector. Various efficiency gaps could be tackled by phasing in fully by 2014 the review of the payment-per-case system based on diagnostic-related groups for acute inpatient care services that has started in 2013. The number of hospital beds in acute care could be further lowered, as low occupancy and turnover rates point to excess capacity. Finally, despite recent progress in increasing the share of surgeries carried out as day cases, more could be done to further develop ambulatory care.

The public sector is the main source of health funding in Slovenia, while private complementary health insurance and out-of-pocket payments each account for around 13% of total health expenditure. The system of complementary health insurance guarantees full co-payment coverage for all services covered by compulsory health insurance. This could lead to unnecessary care. Introducing a fee for some health services, which could not be covered and reimbursed by complementary insurance, would represent a supplementary tool for cost control for the public health purse. There is scope to increase out-of-pocket health expenditure in Slovenia as its burden amounts to slightly above 2% of final household consumption, and is one percentage point lower than the OECD average (OECD, 2011e). Concerns over rising inequalities in access to care could be addressed by differentiating co-payments according to income levels while ensuring full co-payment coverage for chronically ill people.

Instead of taking a passive role and merely reimbursing their clients, insurance companies could be involved in the purchasing process of health services, which would foster cost-control efforts in the medium term. There is also room to continue to rationalise the public benefit basket by reducing the reimbursement rate or delisting certain less medically necessary services, such as spa treatments, non-emergency ambulance transportation or less clinically-effective medicines. The expenditure on pharmaceuticals could be further rationalised and the authorities are considering additional cost-cutting measures in this area.

The tax base of compulsory health insurance could be enlarged by charging working students, as discussed in the education chapter of the 2011 *Economic Survey* (OECD, 2011b), and increasing the contribution rate of pensioners (who are subject to a lower contribution rate than employees). Private complementary health insurance needs to be reformed to be made more sustainable. The system is voluntary, subscribed by almost 95% of individuals and based on a risk-equalisation scheme to avoid cream skimming compensating for differences in risk structure between private insurers. However, premiums paid are flat irrespective of age, which puts the financial situation of the complementary health insurance industry at risk as population ages, potentially leading to insufficient coverage. This problem could be tackled by allowing premium differentiation by age as adopted in a number of countries (OECD, 2004; Thomson and Mossialos, 2009, Table 6).

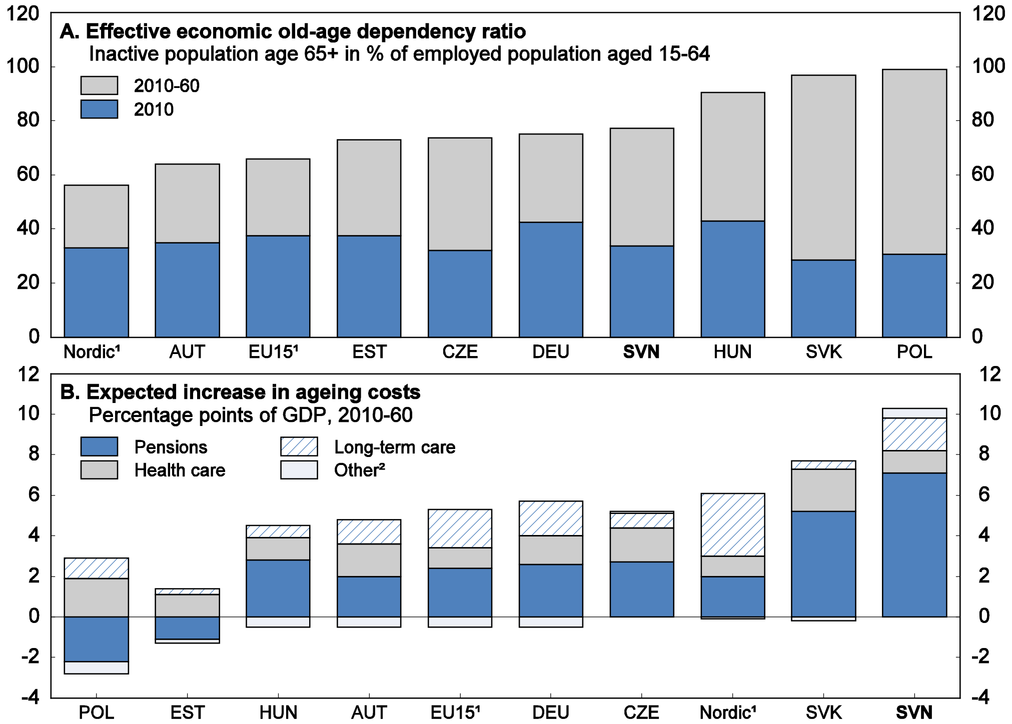
Box 3. Core recommendations to pursue fiscal consolidation

- Focus fiscal consolidation on permanent measures while letting automatic stabilisers operate.
- Improve the composition of the fiscal adjustment by restructuring and further increasing recurrent taxes on residential property, and refraining from reducing taxes without adopting offsetting measures.
- Continue to reduce high-income earners' eligibility for family benefits and strengthen means testing of education-related benefits.
- Continue to gradually cut the combined generosity of unemployment benefits, social assistance and other transfers for the unemployed and inactive persons to increase work incentives and strengthen fiscal sustainability.
- Raise pupil-teacher ratios in pre-primary and lower secondary education and class sizes in primary and lower secondary education to reduce costs. Introduce universal tuition fees along with means-tested grants and loans with income-contingent repayments to boost spending efficiency.
- Further rationalise the public health benefit basket and shift from inpatient to ambulatory care.
- Broaden the tax base of compulsory health insurance to working students and raise contribution rates for pensioners.
- Bolster the credibility of the expenditure rule by transparently setting its parameters, defining escape clauses and adopting a corrective mechanism for deviations from the rule.
- Allow IMAD to take over the role of the fiscal council to strengthen the fiscal framework.

Containing the pressure of population ageing on pensions and long-term care

The ratio of people aged 65 years and over to the total number of employed is projected to more than double by 2060. Slovenia will therefore face major age-related spending pressures, in particular on pensions and long-term care (Figure 9). A pension reform was adopted in December 2012, which is a major achievement given difficulties of implementing structural reforms in Slovenia. However, additional reforms to contain the increase in age-related expenditure on pensions are needed to promote intergenerational equity and safeguard fiscal sustainability.

Figure 9. Challenges related to population ageing are immense



1. Unweighted averages.
2. Education and unemployment benefits.

Source: European Commission (2012), *The 2012 Ageing Report: Economic and Budgetary Projections for the EU27 Member States (2010-2060)*, European Economy, No. 2.

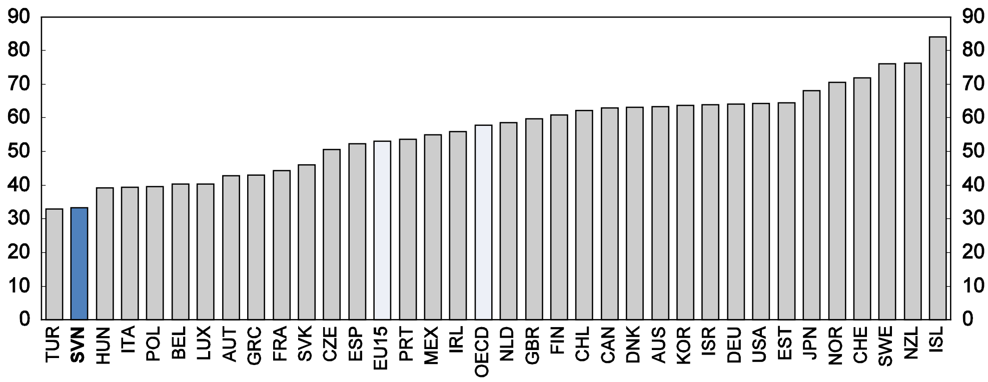
Reforming pensions

As discussed in the previous *Economic Surveys* (OECD, 2009a; 2011b), Slovenia has one of the least sustainable pension systems in the OECD, due to a combination of significant pension generosity and population ageing. The share of public pension expenditure, currently around 11% of GDP, was projected to rise by around 7 percentage points by 2060 prior to the adoption of the recent pension reform (Figure 9, Panel B), with most of the change likely to occur after 2030 (European Commission, 2012d). A parametric reform of the first pension pillar that would have reduced the rise in public spending to around 4.5 percentage points of GDP by 2060 was voted down in a referendum in mid-2011. A new reform was adopted by parliament in December 2012. It is expected to increase the effective retirement age by around two and a half years, to 62 for women and by nine months to 63 for men, by 2020. Pension indexation has been cut to 60% of wage growth and 40% of inflation. However, the reform should generate even smaller savings. It will stabilise public spending on pensions as a share of GDP (at around 11%) only until 2020, which is then projected to increase by 5 to 6 percentage points of GDP until 2060. In this context, the authorities acknowledged that a new pension reform is needed in the near future.

The low effective retirement age, which now contributes to one of the lowest labour participation of older workers in the OECD (Figure 10), would be increased if the pension eligibility age (both statutory and minimum) were raised further and contributory periods made longer. Eventually, pensionable ages should be linked to life expectancy. Penalties (bonuses) for early (deferred) retirement are still too low to encourage longer activity. Finally, numerous special pension regimes (policemen, firemen, pilots, miners, etc.) offer generous early retirement provisions, which should also be tightened.

Figure 10. Labour force participation rate of older workers is low

Per cent, age 55-64, 2011



Source: OECD (2013), *OECD Employment and Labour Market Statistics* (database), March.

The authorities could also consider further reducing the replacement rate, which in net terms is expected to reach 59% for men and women, all the more so as pensioners are entitled to family allowances and a seniority allowance above age 65. Extending the reference period for the calculation of the pension base by moving to a lifetime concept would be a step in the right direction. It would need to be complemented by a less generous adjustment of past earnings to the time of retirement for changes in standards of living and/or lower rates at which benefits accrue. Inflation should also have a higher weight in the pension benefit indexation formula. However, old-age poverty rates are close to 20% in Slovenia, partly as a result of a low average insurance period of 32 years to get a pension, with a minimum of 15 years of contributions to retire at the age of 65. This calls for beefing up social assistance for low-income pensioners before pension adequacy increases with the recommended raise in the minimum insurance period to receive a pension. The recent creation of a consultative pension register should enhance transparency of accrued pension rights and help to reduce poverty risks in retirement.

Developing long-term care

At close to 1.3% of GDP in 2010, long-term care (LTC) now accounts for a relatively small share of GDP, but population ageing will at least double it by 2060 (European Commission, 2012d). To improve the provision and financing of LTC, Slovenia could take stock of the experience of other OECD countries (Colombo et al., 2011). There has been a convergence in the OECD towards adopting a collectively financed system that provides a universal eligibility for a basic package of care, with elements of income and/or asset means testing to strike a balance between protection and fiscal sustainability. In Slovenia, such a system could be financed by a dedicated social insurance scheme levied on the working-age population and on retirees, as implemented in Germany and currently planned by the authorities. The levy is expected to combine current sources of financing of LTC, which would increase the transparency of the new system. With population ageing, charging retirees would ensure a better pooling of financing across generations. Increasing user cost-sharing for LTC, for instance for the cost of board and lodging in nursing homes, would also help to contain public spending and mitigate moral hazard risks.

Greater use of home care, instead of more costly institutional care, would also contribute to reduce LTC expenditure. Incentives to use home care in Slovenia are reduced by higher user cost-sharing and lower rights for services than in institutional settings (Prevolnik Rupel et al., 2010). Creating a level playing field in the accessibility to health services is thus necessary. At the same time, regulations for admissions to institutional care could also be tighter, as in the case of the Czech Republic and Finland, but a careful selection is needed as institutional care could be more cost-effective for high-need users or users residing in remote areas. Giving patients greater autonomy to organise their own care with a system of vouchers, as adopted in the Nordic countries, could enhance competition among home care providers and lower the prices of services and municipalities' expenditure.

Box 4. Core recommendations to reform the pension system and long-term care

- Pursue pension reform by gradually raising the pension eligibility age and contributory periods, eventually indexing them to life expectancy.
- Consider further cutting replacement rates by lowering effective accrual rates and calculating pension rights over lifetime contributions.
- Implement reform plans for long-term care financing by setting up a specific funding system levied on the working-age population and pensioners.
- Promote home care development by creating a level playing field with institutional care for accessibility to health services and giving patients more freedom to organise their own care with a system of vouchers.

Easing economic adjustment through more flexible labour and product markets and promoting green growth

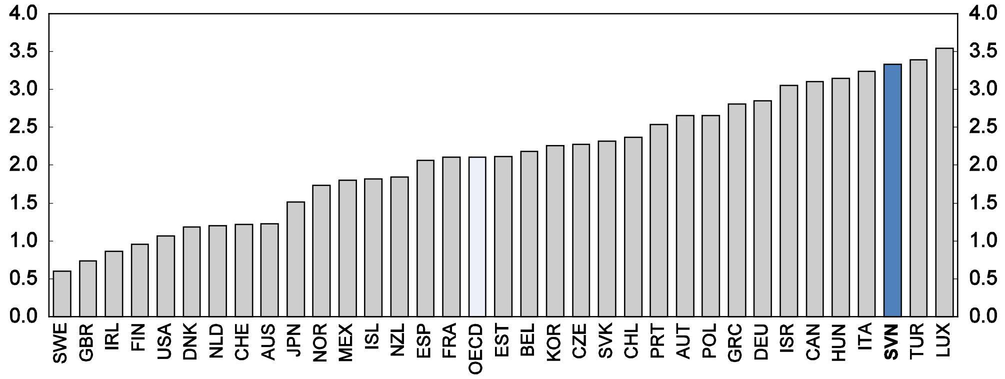
Enhancing product market competition

Product market reforms would raise productivity and potential output and help Slovenia to benefit more extensively from globalisation. Promoting foreign direct investment and reducing public ownership would improve corporate governance and management practices as well as boost competitiveness through direct technology transfers and spillovers. The privatisation programme should be underpinned by a clear distinction between strategic and non-strategic holdings, especially as the extent of state-ownership is difficult to assess owing to large and complex cross-holdings (OECD, 2011b). The list of assets to be privatised is expected to be defined as part of the asset management strategy and implemented by the sovereign holding company. Even though such a list has been proposed by the government, it has not been approved by parliament yet. To improve corporate governance, it is important to strengthen the autonomy of the board and management of the sovereign holding company and state-owned enterprises by allowing them to fulfil their duties with integrity and objectivity and shielding their members from dismissal during their term. Moreover, it is important to establish high quality disclosure and transparency at both the aggregate and individual SOE level. More generally, corporate governance standards of the remaining state-owned enterprises should conform to international standards of best practice (OECD, 2005; 2011a).

Product market reforms that enhance domestic competition would lower price mark-ups, support household purchasing power, lower exporters' input prices and, by reducing domestic rents, increase incentives for stronger export performance. In particular, it appears important to ease the regulation of professional services, which is the third tightest in the OECD (Figure 11). As this sector also has a strong potential for job creation, its liberalisation would enhance the employment effects of labour market reforms and, by facilitating the allocation of resources to the most productive uses, also their efficiency.

Figure 11. Product market regulation in professional services

Index scale of 0-6 from least to most restrictive, 2008[1]



1. Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.

Source: OECD (2013), "Sectoral Regulation: Professional services", *OECD Product Market Regulation Statistics* (database), January.

The Competition Protection Office has become formally independent, which is welcome, but the authorities acknowledge that some remaining procedural conditions still need to be accomplished. Also, its resources, which were already limited, have been significantly cut. The competition watchdog should be better resourced and independent to perform its role efficiently and support the implementation of competition-enhancing reforms.

Strengthening safety nets

The crisis has significantly worsened labour market outcomes. Half of the unemployed have been searching for a job for one year or more and labour market mismatches have increased, as reflected by a simultaneous increase in job vacancy and unemployment rates between 2010 and 2011. These developments call for strengthening active labour market programmes (ALMPs) to support employment and ensure that the long-term unemployed remain attached to the labour market. There is therefore a case for sheltering resources devoted to training and job search services from fiscal consolidation efforts. Unemployment benefit coverage is tight, with only a third of jobless people eligible, owing to strict contribution requirements, even though these have been somewhat relaxed recently. A drawback of this set-up is that those excluded from coverage get less attention in terms of job counselling and activation, even though they can draw on other forms of income support, in particular social assistance (OECD, 2009b). Beyond streamlining administrative costs, merging the Employment Service of Slovenia and the Centres for Social Work would create conditions for equal access of the unemployed to ALMPs.

Reducing labour market segmentation

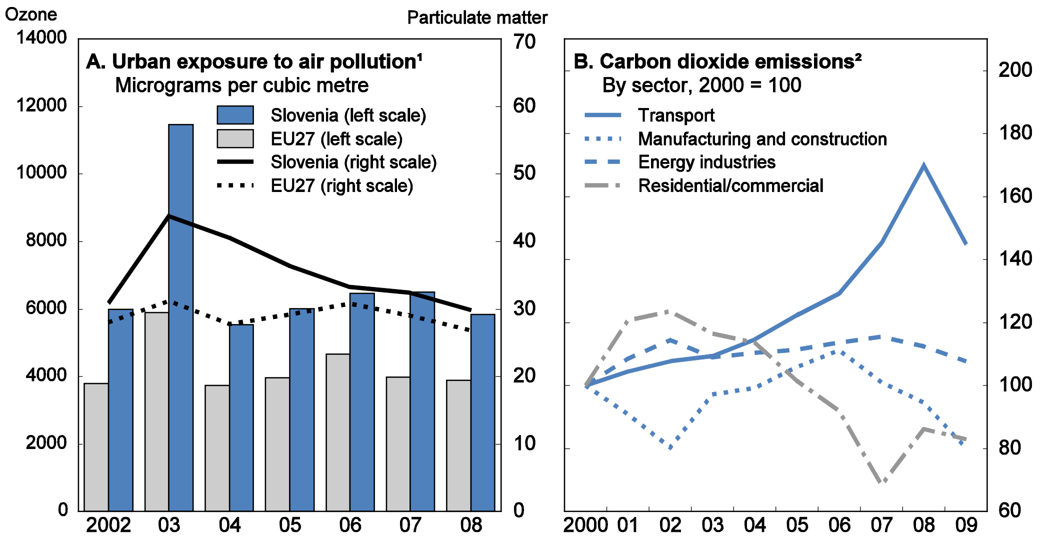
Another challenge is to reallocate labour from declining non-tradable sectors, such as construction, to tradable activities. However, reforms have often been difficult to implement, in part because it is easy to trigger referendums against them and a previous labour market reform was rejected by referendum in 2011. Labour market dualism was high in Slovenia until end-2012, which is not only economically inefficient but also socially unfair because younger and low-skilled workers face difficulties staying in employment. Slovenia has had one of the strictest degrees of protection of regular employment in the OECD, as discussed in the labour market chapter of the 2009 *Economic Survey* of Slovenia (OECD, 2009a). However, the recent labour market reform has reduced differences in contract provisions across workers.

The recently adopted measures reduce the protection of regular employment by alleviating cumbersome administrative procedures and conditions for dismissals, including easier notification procedures, shorter notice periods, and reduced severance payments; the conditions under which dismissals are unfair have also been relaxed; and the practice of reinstatement is foreseen to be made legally more predictable. On the other hand, the reform tightens the protection of fixed-term contracts by introducing redundancy payments and, with some exceptions, limiting up to two years fixed-term employment for a given job. It also mandates a 25% cap for temporary agency workers in a company (except for small firms). Student work, which benefits from a preferential tax and regulatory treatment, has been made somewhat less attractive to employers and students. Further phasing out this preferential treatment, as analysed in the education chapter of the 2011 *Economic Survey* (OECD, 2011b), would also curb labour market inequities.

Making growth more environmentally friendly

Environmentally friendly policies are important to promote a sustainable recovery and growth, together with policies to improve the functioning of the labour and product markets. While the recession has curbed greenhouse gas emissions, this cannot be expected to last when the economy recovers. Also improving the quality of air remains a challenge, notably to improve health outcomes. In Slovenia, urban exposure to air pollution is relatively high (Figure 12, Panel A) owing to an extensive use of private cars in urban centres and wood-burning stoves for heating purposes (OECD, 2012c). Although Slovenia is one of the few OECD countries with an explicit taxation of carbon dioxide emissions and this tax has been beefed up of late, carbon dioxide emissions have grown steeply in the transport sector, with road transport accounting for the bulk of emissions (Figure 12, Panel B). Significant growth in fuel consumption is one of the main drivers, which could be addressed by tax policies (see also below).

Figure 12. Air pollution indicators



1. Population weighted data. For ozone (O_3) this covers the yearly sum of maximum daily 8-hour mean ozone concentrations above a threshold; for particulate matter (PM_{10}), it covers annual mean concentrations at background stations in agglomerations.
2. Excludes international marine and aviation bunkers; sectoral approach.

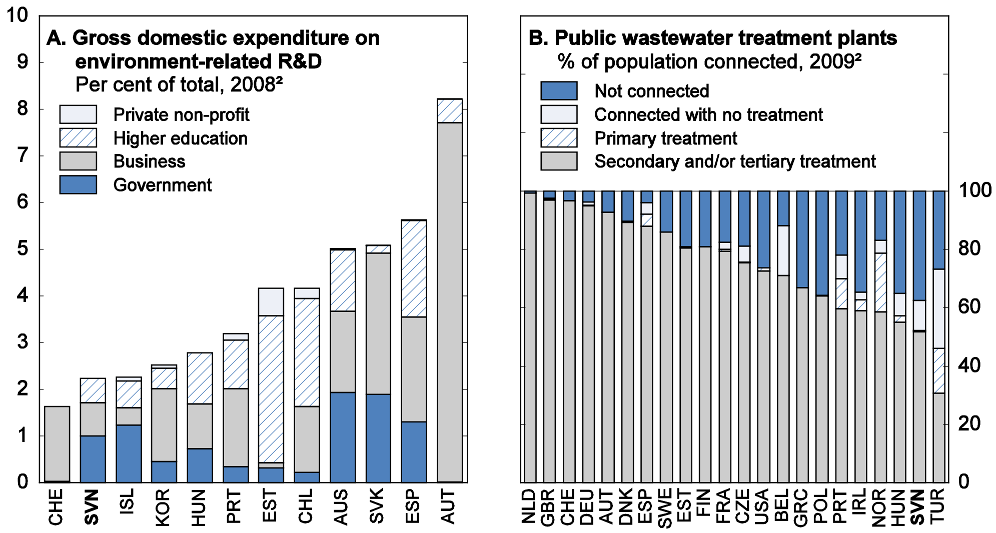
Source: OECD (2012), *OECD Environmental Performance Review: Slovenia 2012*.

Slovenia's extraordinarily rich biodiversity and landscapes continue to be affected by habitat loss and fragmentation due to urbanisation, the development of transport infrastructure and intensive agriculture. More progress is needed to strengthen integration of environmental considerations in economic and structural policies. Slovenia raises a comparatively large amount of environmentally related taxes, which were around 3% of GDP in 2010, the fifth highest share in the OECD. However, as in many other countries, the largest share of environmentally related taxes is accounted for by fuel taxes. While overall effective tax rates on energy are generally at or above the OECD average level (albeit transport fuel rates are at the lower end among other European OECD countries), high rates of fuel consumption growth, partly associated with transit traffic, have made for relatively high revenue (OECD, 2013a).

There is room to reassess environmental taxation to better reflect externalities and contribute to fiscal consolidation. Despite recent hikes, the effective tax rate on diesel is too low relative to that on gasoline – 35% lower in terms of energy content and almost 40% in terms of carbon dioxide (CO_2) emissions (OECD 2013a). Gradually equalising tax rates for diesel and petrol and introducing congestion charges would help to reduce emissions. Recent hikes in motor vehicle taxation depending on emission norms is a step forward, but exemptions that apply in the case of commercial use of diesel fuel could also be phased out. Taxes applied to other fuels (such as heavy fuel oil, gas oil used for heating, and coal and coke products) could better reflect the environmental costs associated with emissions of greenhouse gases and traditional air pollutants. Taxes on other externalities, such as waste generation or water pollution, are small or non-existent. Slovenia needs to reconsider environmentally harmful subsidies (OECD, 2013b), such as support for coal-fired energy plants, to avoid locking long-term investment in environmentally harmful projects and strengthen financing of environmental infrastructure by local authorities to realise economies of scale.

Green innovation and its dissemination represent a fairly unexploited source of green growth (OECD, 2012c). In spite of recently increased spending on environment-related R&D (Figure 13, Panel A), the link between public and business sector has to be strengthened to apply research outcomes to commercially viable solutions. Recently created Centres of Excellence and Centres of Competencies are a good instrument to stimulate collaboration of public research organisations with the business sector. Research vouchers introduced to encourage companies to hire public research organisations are also the right step forward, which could tap more effectively on EU funds. Boosting municipal/household wastewater treatment, which is less widespread than in other countries (Figure 13, Panel B) is also needed. While building new treatment plants could require important resources, a cost-effective option in some cases would be to build artificial wetlands to treat domestic sewage and industrial wastewater (OECD, 2012c).

Figure 13. Environmental performance indicators for R&D expenditure and wastewater treatment[1]



1. R&D: research and development.
2. Or latest available year.

Source: OECD (2012), *OECD Environmental Performance Review: Slovenia 2012*.

Box 5. Core recommendations for sustainable growth

- As currently envisaged in Slovenia to ease the progress of economic reforms, tighten criteria to veto a law by referendum.
- Reduce state ownership in the economy, ease regulation of professional services and strengthen the Competition Protection Office.
- Further reduce labour market dualism by phasing out the preferential treatment of student work.
- Broaden access of unemployed to active labour market policies by merging the Employment Service of Slovenia and the Centres for Social Work.
- Use more extensively research vouchers, funded with EU funds, to promote green innovation.
- Align tax rates for diesel and petrol and consider introducing congestion charges.

Bibliography

Andrews, A.M. (2010), "State-Owned Banks, Stability, Privatization, and Growth: Practical Policy Decisions in a World Without Empirical Proof", *IMF Working Paper*, No. WP/05/10, International Monetary Fund.

Arnold, J., B. Brys, C. Heady, Å. Johansson, C. Schwellnus and L. Vartia (2011), "Tax Policy for Economic Recovery and Growth", *The Economic Journal*, Vol. 121, No. 550, *http://dx.doi.org/10.1111/j.1468-0297.2010.02415.x*.

Bouis, R., O. Causa, L. Demmou, R. Duval and A. Zdzienicka (2012), "The Short-Term Effects of Structural Reforms: An Empirical Analysis", *OECD Economics Department Working Papers*, No. 949, OECD Publishing, *http://dx.doi.org/10.1787/5k9csvk4d56d-en*.

Brown, M., T. Jappelli and M. Pagano (2009), "Information Sharing and Credit: Firm-Level Evidence from Transition Countries", *Journal of Financial Intermediation*, Vol. 18, No. 2, Elsevier, *http://dx.doi.org/10.1016/j.jfi.2008.04.002*.

Colombo, F., A. Llena-Nozal, J. Mercier and F. Tjadens (2011), *Help Wanted? Providing and Paying for Long-Term Care*, OECD Health Policy Studies, OECD Publishing, *http://dx.doi.org/10.1787/9789264097759-en*.

Court of Audit (2012), "Efficiency of the Preparation of Budgets of the Republic of Slovenia for the Years 2011 and 2012", summary of the audit report.

Damijan, J. (2012), "What Went Wrong in Slovenia?", OpEd in *Die Presse*, 8 September.

European Commission (2012a), *Fiscal Sustainability Report,* European Economy, No.8.

European Commission (2012b), "Possible Reforms of Real Estate Taxation: Criteria for Successful Policies", *European Economy - Occasional Papers*, No. 119, October.

European Commission (2012c), "Council Recommendation on the National Reform Programme 2012 of Slovenia and delivering a Council opinion on the Stability Programme of Slovenia, 2012-2015".

European Commission (2012d), *The 2012 Ageing Report. Economic and Budgetary Projections for the 27 EU Member States (2010-2060)*, European Economy, No. 2.

European Commission (2011), *A Second Chance for Entrepreneurs: Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start,* Final Report of the Expert Group, Enterprise and Industry Directorate-General.

Financial Stability Board (2011), "Key Attributes of Effective Resolution Regimes for Financial Institutions", November.

Hribernik, M. and R. Kierzenkowski (2013), "Assessing the Efficiency of Welfare Expenditure in Slovenia with Data Envelopment Analysis", *OECD Economics Department Working Papers*, OECD Publishing, forthcoming.

IMF (2012a), "From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions", *IMF Staff Discussion Note*, International Monetary Fund, April.

IMF (2012b), *2012 Article IV Consultation – Republic of Slovenia*, International Monetary Fund, November.

Johansson, Å., A. Guillemette, F. Murtin, D. Turner, G. Nicoletti, C. de la Maisonneuve, P. Bagnoli, G. Bousquet and F. Spinelli (2012), "Looking to 2060: Long-Term Global Growth Prospects", *OECD Economic Policy Papers*, No. 3, OECD Publishing, *http://dx.doi.org/10.1787/5k8zxpjsggf0-en*.

Joumard, I., M. Pisu and D. Bloch (2012), "Less Income Inequality and More Growth – Are they Compatible? Part 3. Income Redistribution via Taxes and Transfers Across OECD Countries", *OECD Economics Department Working Papers*, No. 926, OECD Publishing, *http://dx.doi.org/10.1787/5k9h296b1zjf-en*.

McKinsey (2012), *The Triple Transformation. Achieving a Sustainable Business Model*, 2nd McKinsey Annual Review on the Banking Industry, McKinsey&Company.

Meghir, C. and D. Phillips (2010), "Labour Supply and Taxes", *The Mirrlees Review*, Institute for Fiscal Studies.

OECD (2013a), *Taxing Energy Use: A Graphical Analysis*, OECD Publishing, *http://dx.doi.org/10.1787/9789264183933-en*.

OECD (2013b), *Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels 2013*, OECD Publishing, *http://dx.doi.org/10.1787/9789264187610-en*.

OECD (2012a), *OECD Reviews of Innovation Policy: Slovenia 2012*, OECD Publishing, *http://dx.doi.org/10.1787/9789264167407-en*.

OECD (2012b), "How Are Countries Around the World Supporting Students in Higher Education?", *Education Indicators In Focus*, No. 2, OECD Publishing, *http://dx.doi.org/10.1787/5k9fd0kd59f4-en*.

OECD (2012c), *OECD Environmental Performance Reviews: Slovenia 2012*, OECD Publishing, *http://dx.doi.org/10.1787/9789264169265-en*.

OECD (2011a), *Corporate Governance in Slovenia 2011*, OECD Publishing, *http://dx.doi.org/10.1787/9789264097704-en*.

OECD (2011b), *OECD Economic Surveys: Slovenia 2011*, OECD Publishing, *http://dx.doi.org/10.1787/eco_surveys-svn-2011-en*.

OECD (2011c), *OECD Territorial Reviews: Slovenia 2011*, OECD Publishing, *http://dx.doi.org/10.1787/9789264120587-en*.

OECD (2011d), *Divided We Stand. Why Inequality Keeps Rising*, OECD Publishing, *http://dx.doi.org/10.1787/9789264119536-en*.

OECD (2011e), *Health at Glance 2011: OECD Indicators*, OECD Publishing, *http://dx.doi.org/10.1787/health_glance-2011-en*.

OECD (2009a), *OECD Economic Surveys: Slovenia 2009*, OECD Publishing, *http://dx.doi.org/10.1787/eco_surveys-svn-2009-en*.

OECD (2009b), *OECD Reviews of Labour Market and Social Policies: Slovenia 2009*, OECD Publishing, *http://dx.doi.org/10.1787/9789264068995-en*.

OECD (2005), *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, OECD Publishing, *http://dx.doi.org/10.1787/9789264009431-10-en*.

OECD (2004), *Towards High-Performing Health Systems*, The OECD Health Project, OECD Publishing, *http://dx/doi.org/10.17787/9789264015562-en*.

Prevolnik Rupel, V., M. Ogorevc and B. Majcen (2010), "The Long-Term Care System for the Elderly in Slovenia", *ENEPRI Research Report*, No. 87, European Network of Economic Policy Research Institutes.

Tang, G. and C. Upper (2010), "Debt Reduction after Crises", *BIS Quarterly Review*, Bank for International Settlements, September.

Thomson, S. and E. Mossialos (2009), *Private Health Insurance in the European Union*, Final report prepared for the European Commission, London School of Economics and Political Science.

Annex A1

Progress in structural reform

The objective of this Annex is to review action taken since the previous Survey (February 2011) on the main recommendations from previous Surveys, which are not reviewed and assessed in the current Survey.

Past recommendations	Actions taken and current assessment
A. Product market competition	
Improve public procurement procedures to rule out collusion.	In mid-September 2012, the government amended the public procurement legislation with a view to simplify procedures, increase the accessibility of small businesses to tenders, and boost competition among bidders. Provisions excluding from tenders persons who had managed an insolvent company over the last two years were cancelled, but companies having tax liabilities of EUR 50 or more will not be allowed to compete. Finally, new regulations aim to prevent excessively low bids that could pose a risk for the completion of the project or lead to cost overruns.
B. Innovation	
Strengthen entrepreneurship education in schools.	Progress has been made with the introduction of new courses, transfers of good practices, and teaching methods to develop entrepreneurial skills, supported by teachers' training to acquire relevant competencies.
Have independent institutions evaluate existing programmes supporting innovation.	No action taken.
Reduce administrative dispersion in business innovation support programmes.	No action taken.
Make the public research and development system more responsive to business needs, including projects for non-technological innovations in the service sector. For example, consider giving financial incentives, such as "research vouchers", to companies to hire the services of the public research centres.	A new research voucher has been introduced to encourage companies to hire public research organisations to do research for them.
Expand the network of public/private business support centres to foster entrepreneurial dynamism.	Centres of Excellence and of Centres of Competencies have been launched to stimulate collaboration of public research organisations with the business sector.
C. Labour markets	
Set up an active ageing strategy.	The government has started to prepare an Active Ageing Strategy 2013-20 with emphasis on supporting longer, healthier and more productive working lives, following the Guiding Principles on Active Ageing adopted by the EU Council in December 2012.
D. Pension system	
Strengthen private pension pillar(s).	New tax reliefs for voluntary savings were introduced and significant progress was made with the adoption of the pension reform in December 2012, which notably strengthens risk management, transparency and governance in the supplementary pensions sector and has also streamlined supervision in a single authority.

Past recommendations	Actions taken and current assessment
E. Fiscal sustainability	
Adopt multi-year expenditure ceilings (beyond the current two years), while excluding cyclically sensitive expenditure (in particular unemployment benefits).	No action taken.
Better link spending performance to budgeting.	No action taken.
F. Education	
Evaluate the impact of adult education programmes on labour market outcomes.	Slovenia has renewed its participation in PIACC (Programme for the International Assessment of Adult Competencies).
Reduce the geographical mismatch of childcare places.	New providers of early childhood care were established where local communities could not assure enough kindergarten places.
Introduce quality assurance guidelines and mechanisms to conduct evaluations of the pre-school institutions and ensure that the body that conducts the evaluations is properly resourced.	A pilot project for evaluation has been started.
Better inform potential candidates for vocational and technical training about career opportunities.	No major action taken, though an internet website continues to supply relevant information and several promotional activities were launched in major cities.
Facilitate more flexible transition from vocational to academic tracks to make it easier for vocational students to access higher education.	The transition of vocational students to short cycle higher education has been eased.
To bolster student mobility, ensure adequate financial support is available to students seeking to study abroad	The authorities have continued to co-finance Erasmus schemes to enhance student mobility.
Phase out the grandfathered element in the funding mechanism for higher education and give more weight to performance to better meet institutions' financing needs.	A decree on funding of higher education institutions was adopted, which takes into account students' progress in the variable part of financing. The variable share amounts to 3% and notably takes into account progress in studies and graduation rates.
Develop study programmes that are more attractive to prospective foreign students and relax restrictions on offering courses in non-Slovenian languages.	Tenders encouraging the development of study programmes in foreign languages were introduced in 2012.
To improve accessibility of adult education, put in place targeted subsidies to reduce adult education costs paid by individuals with low educational attainment levels, who are also most likely to benefit from these programmes.	No action taken.
G. Foreign investment and corporate governance	
Lower the administrative burden of the tax system through reductions in the regularity of tax payments and the complexity of tax compliance.	Changes to the value added tax (VAT) system were introduced to reduce administrative burdens (electronic invoicing, simplifications of filing procedures, increase in the threshold to EUR 50 000 under which the taxable person is exempt from VAT). Simplifications in personal and corporate income taxes were introduced for companies and individuals performing business activities with a yearly turnover below EUR 50 000.
Review existing direct financial incentives and the performance of the special economic and customs ones to make sure that such support is cost effective and is not biased against investment in non-traded goods and services sectors.	The preferential tax regime in economic zones is limited in time. The existing regime will expire by the end of 2013. The Free Koper zone is currently the only economic and customs zone operating in Slovenia.
Streamline processes for accessing business premises, land and building permits.	No action taken.

Chapter summaries

Chapter 1. Banks' restructuring and smooth deleveraging of the private sector

Slovenia is facing the legacy of a boom-bust cycle that has been compounded by weak corporate governance of state-owned banks. The levels of non-performing loans and capital adequacy ratios compare poorly in international perspective and may deteriorate further, which could require significant bank recapitalisation. Updated bottom-up (i.e. loan by loan) stress tests are needed to evaluate the extent of the problems, as the situation has deteriorated rapidly since a similar exercise was done for the two main state-owned banks in mid-2012. To foster the credibility of the new tests, the main results and underlying assumptions should be made public. The creation of the Bank Asset Management Company (BAMC) should allow recognition of problems by ring-fencing impaired assets, which would create conditions for an orderly resolution of non-viable banks and a rapid privatisation of viable banks. To that end, the process of asset transfer and their management has to be transparent and isolated from political influences by ensuring full independence of the BAMC. To achieve smooth deleveraging of the non-financial sector, viable but distressed enterprises should be restructured while insolvent firms should be swiftly liquidated. The main challenge is to improve inefficient insolvency procedures that are too long and result in low recovery rates. Development of equity markets can also facilitate smoother corporate deleveraging by facilitating equity raising through privatisation and entry of foreign investors. Finally, to prevent future crises, banking supervision should be enhanced further.

Chapter 2. Restructuring welfare spending

Restoring fiscal sustainability is a major challenge in Slovenia. Yet, the performance in terms of expenditure control is poor and public expenditure on social spending increased briskly during the crisis, significantly more than on average across the OECD. Despite recent progress in reforming the pension system, Slovenia continues to face major age-related spending pressures. Reforming the welfare state would help achieve fiscal consolidation, increase the quality of fiscal adjustment and address long-term fiscal sustainability challenges. This could be done without significantly worsening income inequality, which is low in Slovenia. Despite recent progress, cash transfers do not seem to be sufficiently means tested. Partly driven by generous social transfers, average effective tax rates on returning to work from inactivity and unemployment are high and could be further cut gradually. Efficiency frontier analysis suggests there is scope to improve spending efficiency without undermining the quality of in-kind services on secondary education, health care and public administration. There is excess capacity in pre-school and compulsory education and the allocation of tertiary education services is regressive. The delivery of health care could be improved by rationalising inpatient care and enhancing cost-effective primary care, which would generate savings in the medium term. Further increasing the effective retirement age and reforming the financing of health and long-term care are the main policy priorities to contain the pressure of population ageing on expenditure.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Slovenia were reviewed by the Committee on 6 March 2013. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 19 March 2013.

The Secretariat's draft report was prepared for the Committee by Rafał Kierzenkowski and Olena Havrylchyk under the supervision of Pierre Beynet. Research assistance was provided by Desney Erb.

The previous Survey of Slovenia was issued in February 2011.

Further information

For further information regarding this overview, please contact:

Mr. Pierre Beynet, e-mail: pierre.beynet@oecd.org,
tel.: +33 1 45 24 96 35; or
Mr. Rafał Kierzenkowski, e-mail: *rafal.kierzenkowski@oecd.org*;
tel: +33 1 45 24 90 62.

See also *http://www.oecd.org/eco/surveys/Slovenia*.

How to obtain this book

This survey can be purchased from our online bookshop: *www.oecd.org/bookshop*.

OECD publications and statistical databases are also available via our online library: *www.oecdilibrary.org*.

Related reading

OECD Economic Surveys: *OECD Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at *www.oecd.org/bookshop*.

OECD Economic Outlook: More information about this publication can be found on the OECD's website at *www.oecd.org/eco/Economic_Outlook*.

Economic Policy Reforms: Going for Growth: More information about this publication can be found on the OECD's website at *www.oecd.org/economics/goingforgrowth*.

Additional Information: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's website at *www.oecd.org/eco*.

Economics Department Working Papers: *www.oecd.org/eco/workingpapers*

OECD work on Slovenia: *www.oecd.org/slovenia*.

