IMAD

economic issues 2011

Economic Issues 2011
Ljubljana, August 2011

Publisher: IMAD, Ljubljana, Gregorčičeva 27
Director: Boštjan Vasle, MSc
Editors in Chief: Marijana Bednaš, MSc, Alenka Kajzer, PhD, Marjan Hafner

Economic Issues 2011 were prepared by:

I. Fiscal developments and policy: Marijana Bednaš, MSc (editor in chief, Summary, Fiscal development and policy in the EU, Analysis of the cyclically adjusted balance, Macroeconomic assumptions in the consolidation of public finances, Fiscal policy challenges in the process of consolidation of public finances); **Gonzalo Caprirolo, MSc** (General government debt, Long-term sustainability of public finances, Fiscal framework, Assessment of the consolidation of public finances in the Stability Programme); **Marko Glažar, MSc** (Estimating the cyclically adjusted balance); **Jasna Kondža** (Budget aggregates of the general government sector, Assessment of the consolidation of public finances in the Stability Programme); **Ana Murn, PhD** (Subsidies, Budgeting); **Dragica Šuc** (Financial flows between Slovenia and the EU budget)

II. Impact of the economic crisis on the labour market and key challenges: Alenka Kajzer, PhD (editor in chief, Summary, Employment rate, Flexible forms of employment, Unemployment, Intervention acts aimed at preserving jobs, Other changes in labour market regulation, Challenges); Lidija Apohal Vučković (Other changes in labour market regulation, Challenges); **Arjana Brezigar Masten, PhD** (Natural rate of unemployment – NAIRU, Intervention acts aimed at preserving jobs); **Matevž Hribernik** (Economic crisis and its impact on the labour market in the EU); **Saša Kovačič** (Wage movements in public-sector activities, The minimum wage); **Tomaž Kraigher** (Number of persons in employment); **Mojca Lindič, MSc** (Unemployment, Active employment policy, Passive labour-market policy measures); **Urška Lušina, MSc** (Intervention acts aimed at preserving jobs); **Ana Tršelič Selan, MSc** (Wage movements in the private sector)

III. Impact of the financial crisis on the credit market in Slovenia: Marjan Hafner (editor in chief, Summary, Credit market trends, Structure of sources of finance, Bank sources, Risks to the lending activity); **Arjana Brezigar Masten, PhD** (Corporate borrowing in Slovenia); **Gonzalo Caprirolo, MSc** (Reduced possibilities to refinance liabilities due); **Barbara Ferk, MSc** (Household borrowing, Deterioration of the quality of bank investments); **Urška Lušina, MSc** (Corporate borrowing in Slovenia); **Matija Rojec, PhD** (The importance of foreign sources of finance)

Translators: Nina Barlič, Sebastijan Razboršek Maček, Marija Kavčič, Mojca Piskernik, Nataša Zajec Herceg
Language Editing: Amidas d.o.o.

Figures: Marjeta Žigman
Design: Katja Korinšek, Pristop
DTP: Ema Bertina Kopitar

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I.
Fiscal development and policy

Summary

Following a significant deterioration in 2009, the general government deficit remained at a high level in the EU in 2010 and general government debt rose apace. *The vast majority of EU Member States are thus subject to excessive deficit procedures, and are thus required to take measures in the coming years to consolidate their public finances. In its spring forecast, the European Commission projects that public finances in the euro area and the EU will be shored up this year (with the exception of Estonia, Denmark and Slovenia), a trend that is expected to continue into next year. However, the average deficit will still exceed 3% of GDP. In the previous two years, the average general government debt relative to GDP rose by 17.7 p.p. in the EU and 15.2 p.p. in the euro area. In the euro area, Ireland, Greece, Portugal and Spain saw their debt rise the most in 2009 and 2010. These countries also have the highest debt levels relative to GDP (along with Belgium) and are facing the largest problems securing financing to settle their debt obligations and cover their budgetary needs. On top of measures that directly increased debt, last year many EU Member States issued extensive guarantees in conformity with existing state aid rules, which increases their potential liabilities.*

To ensure the long-term stability of the euro area, a permanent European Stability Mechanism (ESM) was formed this year, and the need for better coordination of fiscal policies in the EU and the euro area led to the introduction of far-reaching changes to the system of economic governance and the creation of the Euro-Plus Pact. *After Greece received a EUR 110 bn bailout package in April last year, the temporary European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) were created. To date, Ireland has been granted EUR 85 bn in support and Portugal EUR 78 bn. As the situation continued to deteriorate, the ECB changed its monetary policy in May 2010, increasing financing for commercial banks and relaunching refinancing operations in US dollars. It also opted to directly purchase public and private debt, which had been completely sterilised last year. As part of measures to ensure the long-term stability of the euro area, a permanent European Stability Mechanism (ESM) was formed this year to succeed the current temporary facilities after June 2013. Just as it is in the temporary facilities, access to ESM aid will be conditional on strict adherence to the macroeconomic adjustment programme, which has to be prepared by the country asking for assistance. The ESM now also introduces the participation of the private sector. The need for better coordination of economic policies has led to far-reaching changes in the system of economic governance in the EU and the creation of the Euro Plus Pact, which requires that participating countries implement a set of specific measures in the next twelve months to strengthen the sustainability of the public finances, foster competitiveness, promote employment and reinforce financial stability. As part of the implementation of the new European strategy, EU2020, and the broader coordination of economic policies across the EU, changes in economic governance were proposed introducing the European semester and closer ex ante coordination of macroeconomic and structural policies. This gives the EU Council, with the support of the European Commission, some leverage over economic policy-making at national level and provides for inclusion of their recommendations into the budgeting process in individual Member States.*

In Slovenia the general government deficit narrowed only marginally in 2010, remaining at a high level (5.6% of GDP). *Following a significant deterioration in public finances in 2009, no major improvement was recorded last year. The gap between revenue and expenditure even widened in the first half of last year, with the bulk of the revenue shortfall being the consequence of lower corporate income-tax receipts. The government therefore adopted a supplementary budget in mid-2010 to adjust the outlays to lower revenue. The biggest spending cuts were made in investment in transport and transport infrastructure, health and defence; there were smaller adjustments in current expenditure and transfers. In the year as a whole, revenue growth was thus even somewhat higher than expenditure growth. Calculations of the cyclically adjusted balance – which require cautious interpretation – show that even though the strong deterioration in 2009 was to a great extent attributable to the deterioration of economic conditions, structural factors of the general government balance have been present since before the crisis and indicate no signs of improvement to date: in 2007, tax cuts were put in place without matching measures to restructure and reduce expenditure. The current precarious state of public finances is thus to a significant degree the product of fiscal policy in the year preceding the crisis, while the financial and economic crisis only worsened the situation. However, the net position relative to the EU budget improved in this period, which, along with the record inflow of EU funds last year, indicates an improved capacity to absorb EU funds.*

The increase in Slovenia's general government debt has been outpacing the euro area average. *Debt was lower than expected last year and remains well below the euro area average; however, in the last two years it has been growing faster than in the euro area in relative terms and is set to more than double by the end of this year compared with the level in 2008. The brisk pace of debt growth is exacerbating the risk that debt will exceed 60% of GDP in case of a renewed shock. Another key risk factor is state guarantees, which already exceed 20% of GDP.*

This year's Stability Programme does not envisage a reduction of the deficit in 2011; what is more, compared with the previous programme, it projects a slower pace of consolidation of public finances through the entire programming period. *Even though this year's Stability Programme envisages a similar economic-policy mix – in certain segments the measures are even more restrictive than projected last year – the planned deficit at the end of the programming period is nevertheless higher. The slower dynamics of consolidation in Stability Programme 2011 are attributed to altered economic circumstances and the macroeconomic scenario, which suggests that the key element of consolidation is the revenue trajectory underpinned by the economy, even though consolidation was declaratively based on reigning in expenditure. In other words, despite greater emphasis on expenditure ceilings in Stability Programme 2011, the pace of consolidation is still substantially conditional on revenue dynamics. In 2011, the general government deficit will remain on a level with last year's, as consolidation of public finances is not slated to begin until next year. The dynamic of this consolidation is the result of this year's increase in expenditure as a share of GDP, which is partially the consequence of a capital increase at the largest state-owned bank, NLB, in the amount of 0.7% of GDP (coupled with a higher share of social benefits and relief, and other expenditure). The expenditure bump caused by bank recapitalisation will not permanently raise general government expenditure (except higher expenditure on interest), but it will slow down consolidation. Had the recapitalisation been completed in 2009, when the European Commission gave Member States the option of awarding state aid to the financial sector as part of stimulus measures, this transaction would not have counted towards general government expenditure or increased the deficit, though it would have increased debt. By 2013, when Slovenia needs to correct this excessive deficit, it will drop to just below 3% of GDP compared with a planned reduction to 1.6% of GDP in the previous Stability Programme. This forecast entails the risk that the ceiling prescribed by the Stability and Growth Pact will be breached even in the event of a moderate deterioration in the macroeconomic environment, since the pace of consolidation still significantly depends on revenue dynamics. With measures not yet fully defined and uncertainty concerning the implementation of several planned measures, substantial fiscal effort will be needed to realise the planned consolidation.*

Although consolidation by means of expenditure cuts produces more permanent results in principle, the planned measures are a departure from the mix of economic policies that has been assessed to be effective. *The consolidation of public finances is underpinned by spending cuts, but expenditure has been contracting more slowly (as a share of GDP) than planned last year. The efforts to reign in compensation of employees in the public sector are inherently emergency measures, with no systemic changes planned in pay and employment policies that would produce more permanent solutions while creating a more stimulating environment for employees. Long-term restrictions on employment in the public sector could significantly affect the quality of public services, in particular in health and social care, where demographic trends alone require more hiring. Implementation of changes in social-protection systems (in particular, pension reform), which could also improve the sustainability of public finances, remains uncertain. The proposed economic-policy mix thus increases the risk that more flexible development expenditure will be crowded out in the event that the planned measures are not implemented, which would be followed by deeper cuts in expenditure on wages, pensions and social transfers. To a larger degree than in the past, the projected growth in investment is contingent on co-financing from EU funds, which could lead to a significant decline in development-oriented expenditure in the event that the absorption of EU funds is not on target. Expenditure-side consolidation of public finances also includes subsidy cuts, which will require a far-reaching intervention in the subsidy structure, based on an assessment of the effectiveness of existing subsidy programmes.*

Slovenia is among the countries with the highest projected ageing-related expenditure according to the European Commission's estimate. *Without a change in policies, this type of expenditure will start to surge as early as this decade. Although most significant in the long term, these contingent liabilities are already affecting the shaping of fiscal policy measures and borrowing costs, as rating agencies have been considering these factors in their sovereign credit ratings to an ever-higher degree. Ensuring the long-term sustainability of public finances will require systemic adjustments: the key will be to reform the pension system and other social-protection systems, and implement measures to raise potential output and create new jobs. Implementation of the pension reform would significantly relieve the fiscal effort, but the task ahead would still be substantial. Since the pension reform will not be implemented next year, however, the state of public finances will dictate further changes that will be even harsher than the currently proposed measures.*

Consolidation of public finances and the closure of the excessive deficit procedure, which has major implications for Slovenia's standing on international financial markets and accessibility of financing for the entire economy, will involve improvements to the efficiency of spending and more far-reaching systemic and structural changes. *It is paramount that greater emphasis be placed on structural measures in the consolidation process, and that these* *measures be adopted as soon as possible and implemented in a timely and comprehensive fashion. Part of the spending cuts can be achieved with savings measures and streamlining, not with linear cuts but with the creation of a system that will allow for greater flexibility of wages and hiring, consistent implementation of measures to improve the efficiency of the public sector, and streamlining of operations. Improving the efficiency and effectiveness of development expenditure would contribute to faster consolidation and have a positive impact on competitiveness. A broader and consistent solution to reducing total expenditure as a share of GDP lies in abolishing inefficient programmes and diminishing the total amount of subsidies amid their restructuring. A positive contribution to competitiveness and potential GDP growth could be achieved by restructuring expenditure, focussing on its role in development and ensuring the long-term sustainability of social security systems. On the revenue side, the scope for increasing the tax burden is limited; to speed up consolidation, it makes sense to raise individual indirect taxes and broaden the tax base.*

Placing debt-to-GDP dynamics on a declining trend will be a key challenge of fiscal and other economic policies in the coming years. *Credible implementation of the fiscal-consolidation programme is a key factor affecting the level of debt and can be influenced with economic policy measures. The vital aspect of this is carrying out of structural reforms to ensure the long-term sustainability of public finances; as early as this decade, pressure on ageing-related expenditure will rise in accordance with the expected demographic trends. Given the expected rise in interest rates and a probable increase in bond yields in the entire euro area, the price at which Slovenia borrows will very likely increase in the coming years; the situation would deteriorate further if consolidation were too slow or if financial markets were to doubt Slovenia's commitment to carry out the necessary measures. This would limit access to financing not only for the state but also for the private sector, which would undermine competitiveness and hamper potential growth. Moreover, more expensive borrowing would affect the quality of the public finances in the consolidation process, as growing expenditure on interest would crowd out the more flexible development expenditure. Better management of state assets, including a sale of a portion of the state's equity holdings, would also have a positive impact on fiscal consolidation and curbing debt growth.*

The Slovenian fiscal framework has been substantially redefined in the last two years. *Changes have occurred in several areas. Since 2010, it has been possible to use not just one but multiple macroeconomic forecasts in budget preparation, which can, however, undermine accountability. Another change involves the consideration of envisaged but not yet adopted economic policies in macroeconomic scenarios that form the basis for fiscal projections in the programming period. In April 2011, the Government adopted a medium-term fiscal framework as a basis for the Stability Programme – Update 2011, which expanded the definition of fiscal target and made explicit the link between the target the government is pursuing and the expenditure ceiling defined as a fiscal rule. The introduction of the fiscal rule allows for the framing of a global expenditure framework and limits potential expenditure increases in the course of the budgetary debate in government or in parliamentary procedure. The way it is calculated, however, entails certain limitations stemming from the changeability of potential output and the combination of discretionary elements, which provides room for adjustment and arbitrariness in setting the expenditure ceiling, undermining the effectiveness of the fiscal rule. The new medium-term fiscal target – a balanced budget position in structural terms – improves the stability of public finances and is more effective at curbing the growth in general government debt. However, the target is not expected to be reached in the programming period (until 2014) but towards the end of the term of the next government, which undermines accountability in the event that it is not met. The establishment of the Fiscal Council, modelled on examples of best practice from certain EU Member States, has created an institution tasked with independently monitoring the implementation of fiscal policy and its compliance with targets. However, in order to boost the formal independence of the Fiscal Council, it would be advisable to change the appointment procedure: instead of being nominated and appointed by the government, members should be nominated by expert institutions and confirmed by the National Assembly, which would also adopt the Fiscal Council's annual reports. This would also enhance the role of the National Assembly in monitoring the implementation of fiscal policy.*

Introduction

Euro area countries face the challenge of how to achieve a sustainable improvement in public finances in order to strengthen the stability of the single currency while simultaneously contributing to the stabilisation of the domestic macroeconomic environment. Following a severe deterioration of public finances in the euro area and the entire EU in 2009, there was an absence of notable positive changes last year. In accordance with the provisions of the Stability and Growth Pact, in the coming years Member States must carry out measures to consolidate their public finances and thus contribute to the stabilisation of the euro area. Slovenia, too, faces the challenge of consolidating its public finances, which is vital to providing a stable macroeconomic framework for growth and ensuring that public finances are sustainable in the medium and long term, when ageing-related expenditure will start surging. Lacking that, other macroeconomic balances will collapse: inflation risk would increase and borrowing conditions on international financial markets tighten.

In this year's fiscal chapter, emphasis has been placed on analysis of the fiscal situation and assessment of the planned consolidation of public finances. The first sections of this chapter lay out last year's fiscal trends in the EU and changes in fiscal aggregates and flows in Slovenia, including an analysis of cyclical and structural factors, financial flows between Slovenia and the EU budget, public debt and the elements of long-term sustainability of public finances. This is followed by in-depth analysis of the planned consolidation of public finances, which is benchmarked to last year's plans, and an assessment of the downside risks to successful deficit reduction until 2013. A special section is dedicated to changes in Slovenia's fiscal framework, which follow the fiscal framework changes at EU level, including the introduction of the European Semester. Finally, based on all the analyses, proposed guidelines for sustainable consolidation of public finances that make it possible to preserve and strengthen their development role are provided.

1. Fiscal Development and Policy in the EU

The budget deficits of EU and euro area countries remained high in 2010, following a sharp deterioration in 2009, with a gradual improvement expected this year. Last year, the general government deficit averaged 6.0% of GDP in the euro area and 6.4% in the EU (down 0.3 and 0.4 p.p. respectively over 2009). Based on assessments of cyclical and structural elements of the deficit, the European Commission concluded that last year's marginal improvement was a result of cyclical factors. All Member States bar Estonia and Sweden posted deficits in 2010, while Denmark, Finland and Luxembourg were the only ones with deficits below 3% of GDP. Only these five countries are not subject to excessive deficit procedures. In its Spring Forecast 2011, the European Commission projects an improvement in public finances for this year in the euro area and the EU (with the deficit dropping to 4.3% and 4.7% of GDP, respectively); only in Denmark, Estonia and Slovenia is the deficit expected to rise, making Slovenia the only country subject to excessive deficit procedure for which the Commission does not expect an improvement this year.

Deficit reduction is expected to proceed in earnest next year, but the average deficit is still projected to exceed 3% of GDP (3.5% of GDP in the euro area, 3.8% of GDP in the EU). Much like this year, consolidation will be underpinned on expenditure cuts rather than on higher revenue. Compared to the Commission's Autumn Forecast, expectations for this year and next improved marginally on average (by 0.3 p.p. in the euro area and 0.4 p.p. in the EU), but public finances will not have improved by as much as forecast in the autumn in Ireland, the Netherlands, Austria and Slovenia (by 0.1-0.2 p.p.), whereas a severe deterioration is projected for Greece (2.1 p.p.).

The vast majority of EU Member States are subject to excessive deficit procedures and hence forced to take measures in the coming years to consolidate their public finances. The severe deterioration of public finances in 2009 triggered the launch of excessive deficit procedures for 24 countries over their breach of the 3% of GDP deficit ceiling laid down in the Stability and Growth Pact. For most Member States, the EC set 2012 or 2013[1] as the deadline for bringing their deficits back below the reference value. Countries subject to excessive deficit procedures provide regular progress reports to the

[1] 2014 for Greece and the United Kingdom, 2015 for Ireland and 2011 for Bulgaria, Malta and Finland.

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

	Actual balance (as a % of GDP)						Cyclically adjusted balance (as a % of GDP)					
	2006	2007	2008	2009	2010	2011*	2006	2007	2008	2009	2010	2011*
Belgium	0.2	-0.3	-1.3	-5.9	-4.1	-3.7	-0.6	-1.4	-1.8	-4.2	-2.8	-2.9
Germany	-1.6	0.3	0.1	-3.0	-3.3	-2.0	-1.6	-0.5	-0.5	-0.8	-2.2	-1.4
Estonia	2.4	2.5	-2.8	-1.7	0.1	-0.6	-0.8	-1.0	-3.8	1.7	2.5	0.3
Ireland	2.9	0.1	-7.3	-14.3	-32.4	-10.5	2.0	-1.8	-7.4	-12.0	-30.3	-9.2
Greece	-5.7	-6.4	-9.8	-15.4	-10.5	-9.5	-6.1	-7.5	-10.4	-14.9	-8.2	-6.1
Spain	2.0	1.9	-4.2	-11.1	-9.2	-6.3	1.5	1.3	-4.1	-9.2	-7.0	-4.3
France	-2.3	-2.7	-3.3	-7.5	-7.0	-5.8	-3.2	-3.7	-3.4	-5.6	-5.1	-3.9
Italy	-3.4	-1.5	-2.7	-5.4	-4.6	-4.0	-4.5	-3.0	-3.2	-3.2	-2.9	-2.6
Cyprus	-1.2	3.4	0.9	-6.0	-5.3	-5.1	-1.2	2.7	-0.1	-5.5	-4.6	-4.5
Luxembourg.	1.4	3.7	3.0	-0.9	-1.7	-1.0	0.6	1.9	2.3	1.5	0.1	0.3
Malta	-2.7	-2.4	-4.5	-3.7	-3.6	-3.0	-2.2	-2.1	-5.3	-2.8	-3.5	-3.0
Netherlands.	0.5	0.2	0.6	-5.5	-5.4	-3.7	0.6	-0.9	-0.5	-3.6	-3.8	-2.5
Austrija	-1.5	-0.9	-0.9	-4.1	-4.6	-3.7	-1.9	-2.0	-2.2	-2.9	-3.7	-3.2
Portugal	-4.1	-3.1	-3.5	-10.1	-9.1	-5.9	-3.6	-3.4	-3.5	-9.1	-8.8	-4.9
Slovenia	-1.3	-0.1	-1.8	-6.0	-5.6	-5.8	-2.8	-2.9	-4.6	-3.6	-3.0	-3.5
Slovakia	-3.2	-1.8	-2.1	-8.0	-7.9	-5.1	-3.6	-3.6	-4.0	-7.4	-7.4	-4.8
Finland	-1.3	-0.1	-1.8	-6.0	-5.6	-1.0	2.7	2.6	2.5	0.7	0.2	0.8
EMU-17	:	-0.7	-2.0	-6.3	-6.0	-4.3	-1.9	-1.7	-2.5	-4.3	-4.4	-3.0
Bulgaria	1.9	1.1	1.7	-4.7	-3.2	-2.7	0.7	-0.4	-0.2	-3.4	-1.4	-1.2
Czech Rep.	-2.6	-0.7	-2.7	-5.9	-4.7	-4.4	-4.1	-2.9	-4.5	-5.1	-4.0	-3.8
Denmark	5.2	4.8	3.2	-2.7	-2.7	-4.1	3.1	2.8	3.0	0.9	0.0	-2.2
Latvia	-0.5	-0.3	-4.2	-9.7	-7.7	-4.5	-3.1	-4.4	-6.3	-6.6	-5.1	-3.1
Lithuania	-0.4	-1.0	-3.3	-9.5	-7.1	-5.5	-2.1	-3.6	-5.4	-7.1	-5.1	-4.7
Hungary	-9.3	-5.0	-3.7	-4.5	-4.2	1.6	-10.9	-6.1	-4.5	-2.0	-2.1	2.7
Poland	-3.6	-1.9	-3.7	-7.3	-7.9	-5.8	-4.1	-2.9	-4.6	-7.1	-7.4	-5.3
Romania	-2.2	-2.6	-5.7	-8.5	-6.4	-4.7	-4.3	-4.9	-8.7	-8.3	-5.2	-3.3
Sweden	2.3	3.6	2.2	-0.7	0.0	0.9	0.4	1.4	1.7	2.6	1.4	1.3
UK	-2.7	-2.7	-5.0	-11.4	-10.4	-8.6	-3.6	-3.8	-5.3	-9.1	-8.2	-6.5
EU-27	-1.5	-0.9	-2.4	-6.8	-6.4	-4.7	-2.2	-2.0	-2.9	-4.8	-4.7	-3.3

Source: Eurostat, EC Spring Economic Forecast 2011.
Note: * EC forecast.

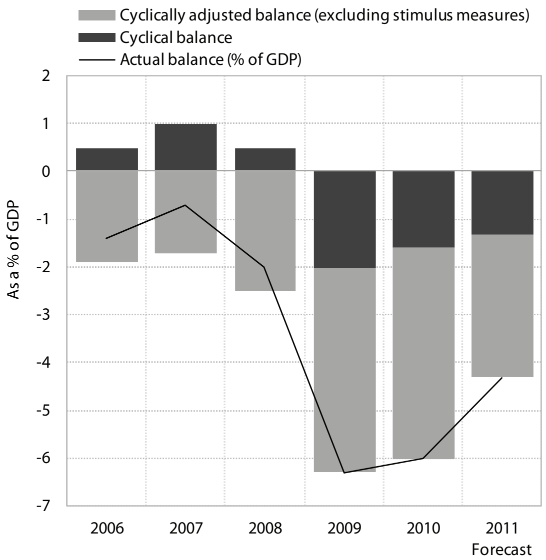
EC on measures to consolidate their public finances. In the event of unforeseen economic circumstances that significantly diverge from the estimate in the recommendation for correction of excessive deficit, the deadline may be extended. The provisions of the Stability and Growth Pact stipulate that countries that do not correct excessive deficits in a certain period face sanctions, which have become harsher in the proposed new package of EU regulations,[3] requiring that the criterion of public debt (60% of GDP) be better reflected in the budgetary surveillance mechanism.

Following a surge in 2009, general government debt continued to rise in the EU and the euro area last

[2] The European Commission's assessment of the cyclically adjusted deficit differs from IMAD's estimates, which we attribute to the different production function methodology and the resulting difference in the output gap estimate. The European Commission has yet to start using the Kalman filter for smoothing the total factor productivity series for Slovenia and several other new Member States (see Section 2.1); at the present, it still uses the Hodrick-Prescott filter for the new Member States. There are also differences in input data: IMAD uses a correction due to a break in the employment series in the national accounts statistics and the forecasts of series used in the calculations differ.

[3] A country subject to excessive deficit procedure will henceforth have to pay a no-interest deposit equalling 0.2% of GDP as soon as the procedure is launched. Failing to heed the recommendations to reduce the deficit automatically triggers a transformation of the deposit into a fine. The sanctions can be stepped up based on a decision by the Council of the EU in the form of an additional deposit equalling one tenth of the difference between the deficit as a share of GDP in the previous year and the 3% reference value. Individual deposits may not exceed the ceiling of 0.5% of GDP.

Figure 1: **Deficit composition of euro area countries, as a % of GDP – cyclically adjusted and actual balance**



Source: European Commission.

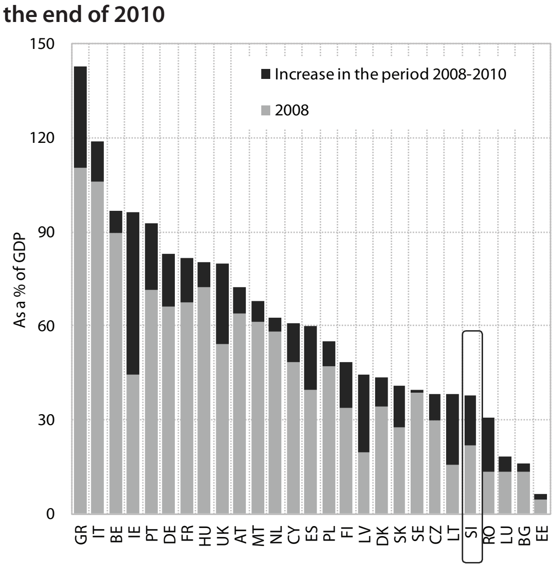
year. In the last two years, general government debt rose by 17 p.p. on average in the EU and 15.2 p.p. in the euro area; last year growth slowed down, but it was still substantially higher than in the period before the crisis (in relative terms, debt actually dropped in 2006 and 2007). In both years, increased borrowing was driven by the need to finance high primary deficits, growing interest expenditure and non-budgetary expenditure that countries earmarked for securing the stability of the financial system, in particularly recapitalisation of financial firms. According to the EC's estimate, non-budgetary expenditure raised the debt level by 3 p.p. on average in the euro area in the past two years. In the euro area, Ireland, Greece, Portugal and Spain saw their debt rise fastest in 2009 and 2010. These countries also have the highest debt levels relative to GDP (in addition to Belgium) and are facing the biggest problems securing financing to meet their debt obligations and to cover their budgetary needs. On top of the measures that directly increased debt, many Member States last year issued extensive guarantees in conformity with existing state aid rules, which has increased the potential liabilities that will be realised if the guarantees are called up.

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

	2006	2007	2008	2009	2010	2011*
Belgium	88.1	84.2	89.6	96.2	*96.8*	*97.0*
Germany	67.6	64.9	66.3	73.5	*83.2*	*82.4*
Estonia	4.4	3.7	4.6	7.2	*6.6*	*6.1*
Ireland	24.8	25.0	44.4	65.6	*96.2*	*112.0*
Greece	106.1	105.4	110.7	127.1	*142.8*	*157.7*
Spain	39.6	36.1	39.8	53.3	*60.1*	*68.1*
France	63.7	63.9	67.7	78.3	*81.7*	*84.7*
Italy	106.6	103.6	106.3	116.1	*119.0*	*120.3*
Cyprus	64.6	58.3	48.3	58.0	*60.8*	*62.3*
Luxembourg	6.7	6.7	13.6	14.6	*18.4*	*17.2*
Malta	63.4	62.0	61.5	67.6	*68.0*	*68.0*
Netherlands	47.4	45.3	58.2	60.8	*62.7*	*63.9*
Austria	62.1	60.7	63.8	69.6	*72.3*	*73.8*
Portugal	63.9	68.3	71.6	83.0	*93.0*	*101.7*
Slovenia	26.7	23.1	21.9	35.2	*38.0*	*42.8*
Slovakia	30.5	29.6	27.8	35.4	*41.0*	*44.8*
Finland	26.7	23.1	21.9	35.2	*38.0*	*50.6*
EMU-17	:	66.2	69.9	79.3	*85.1*	*87.7*
Bulgaria	21.6	17.2	13.7	14.6	*16.2*	*18.0*
Czech Rep.	29.4	29.0	30.0	35.3	*38.5*	*41.3*
Denmark	32.1	27.5	34.5	41.8	*43.6*	*45.3*
Latvia	10.7	9.0	19.7	36.7	*44.7*	*48.2*
Lithuania	18.0	16.9	15.6	29.5	*38.2*	*40.7*
Hungary	65.7	66.1	72.3	78.4	*80.2*	*75.2*
Poland	47.7	45.0	47.1	50.9	*55.0*	*55.4*
Romania	12.4	12.6	13.4	23.6	*30.8*	*33.7*
Sweden	45.0	40.2	38.8	42.8	*39.8*	*36.5*
UK	43.4	44.5	54.4	69.6	*80.0*	*84.2*
EU-27	61.5	59.0	62.3	74.4	*80.0*	*82.3*

Source: Eurostat, EC Spring Economic Forecast 2011.
Note: * EC forecast.

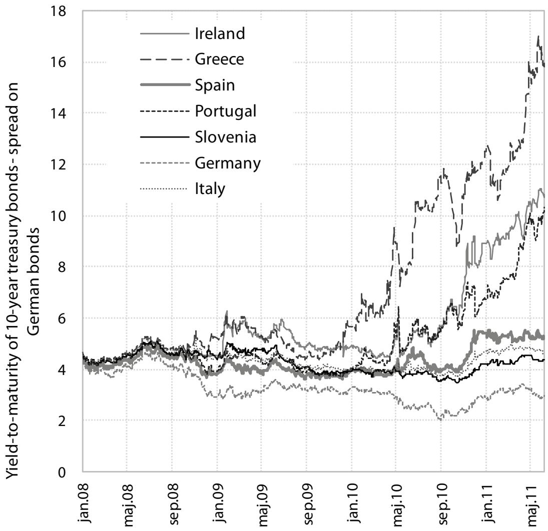
Figure 2: **General government debt in EU countries at the end of 2010**



Source: European Commission.

The temporary European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) were created in 2010 in order to buttress the stability of the euro area. Faced with deteriorating public finances and an inability to secure financing for the coverage of the deficit and loan repayment, in April last year Greece officially requested financial aid from the EC, ECB and IMF.

Figure 3: **Yield to maturity of 10-year treasury bonds in selected countries, in p.p.**



Source: Eurostat.

A EUR 110 bn package was approved and will be disbursed over a three-year period conditional on the implementation of an austerity package that the institutions are monitoring on a quarterly basis. As the debt crisis threatened to escalate, especially in heavily-indebted countries with high deficits, a facility and a mechanism for financial stabilisation were established in May 2010. The EFSF can issue debt instruments in the total amount of EUR 440 bn in order to provide financial assistance in the form of loans to euro area countries that are guaranteed by other euro area members. The EFSM allows the European Commission to contract loans on financial markets on behalf of the Union with the implicit guarantee of the EU budget. The Commission then acts as lender to eligible Member States. The financial support of both mechanisms, which are due to expire in 2013,[4] is conditional on strict criteria regarding the implementation of economic policy measures in the Member State which applies for aid. Thus far, Ireland received EUR 85 bn in November last year to sort out its banking sector and meet its budgetary needs,[5] while in May this year Portugal received EUR 75 bn, a part of which will be earmarked for the restructuring of the financial sector as well.

As the situation deteriorated, the ECB changed the course of its monetary policy in May 2010. Firstly, it abandoned its exit strategy of phasing out liquidity measures, increased funding to commercial banks[6] and relaunched temporary liquidity swaps with the US Federal Reserve (refinancing operations in US dollars). Secondly, it opted to directly purchase public and private debt, a measure coupled with additional sterilisation, which it explained with confidence in the countries' commitment to adhere to fiscal goals and their readiness to accelerate fiscal consolidation where necessary. The ECB says that increased liquidity following the bond purchases was completely neutralised last year by special liquidity withdrawal operations.[7]

In order to secure the long-term stability of the euro area, more permanent financial stability mechanisms were created this year. The creation of a permanent European Stability Mechanism (ESM) was proposed as a means of enhancing the financial stability mechanisms in the euro area. Pending successful completion of national procedures to amend the Treaty on the Functioning of the EU (Lisbon Treaty), which is a precondition for the implementation of the ESM, the mechanism would succeed the temporary EFSF and EFSM mechanisms when they are scheduled to expire in June 2013. The EMS would be triggered when necessary to protect the stability of the euro area as a whole. Access to EMS aid will be conditional on implementation of policy measures based on a macroeconomic adjustment programme and a thorough analysis of the sustainability of treasury borrowing, to be carried out by the Commission and the IMF in liaison with the ECB. With a subscribed capital of EUR 700 bn, the ESM will have an actual lending capacity of EUR 500 bn.[8] One innovative point is that the ESM also

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[4] The EFSF will handle due liabilities beyond June 2013, until all the funds granted to Member States are repaid in their entirety and its liabilities stemming from the issuance of financial instruments are settled. Portions of existing loans that have not yet been disbursed and financed will presumably be transferred to the European Financial Stabilisation Mechanism (e.g. instalments that will have to be paid out and financed after the implementation of the European Financial Stabilisation Mechanism).

[5] The aid package comprises contributions from the IMF (EUR 22.5 bn), the EFSM (EUR 22.5 bn) and EFSF (EUR 17.7 bn), and bilateral loans from the United Kingdom (EUR 3.8 bn), Sweden (EUR 0.6 bn) and Denmark (EUR 0.4 bn); Ireland is participating with EUR 17.7 bn.

[6] A six-month operation of long-term refinancing with full allotment at interest determined as average base interest in main refinancing operations during the duration of this operation (EUR 36 bn was allotted until 12 May); Three-month long-term refinancing operations (26 May and 30 June) in auction format with fixed interest and full allotment.

[7] At the end of 2010, the Eurosystem intervention on bond markets totalled EUR 73.5 bn, while liquidity in the exact same amount was mopped up on the money market.

[8] The ESM's subscribed capital will total EUR 700 bn, of which EUR 80 bn will be paid-up capital that euro area members will provide in five equal annual instalments starting in July 2013. The distribution key for contributions by the individual countries to the subscribed capital will be based on the distribution key for the ECB paid-up capital. Slovenia will contribute 0.428% or EUR 342.4 m. By ratifying the treaty establishing the ESM, Member

allows for the involvement of the private sector. With consideration for the specific circumstances, recipient countries will have to provide an appropriate form of involvement by the private sector in conformity with IMF practice. After July 2013, clauses on joint action by states and private lenders will thus be included in all new euro area treasury bonds with a maturity of over one year.

The need for better coordination of economic policies in the EU and the euro area led to the introduction of far-reaching changes in the system of the Union's economic governance and the creation of the Euro-Plus Pact. The reactions of financial markets to the fiscal problems of Greece, Ireland and Portugal, and the possibilities of a deepening of the debt crisis in the euro area, highlighted the weaknesses of the existing mechanism for the coordination of economic policies in the euro area. During the course of the crisis, the provisions of the Stability and Growth Pact as a mechanism for the coordination of fiscal policies in the euro area turned out to be too loose and not sufficiently binding to preserve the stability of the single currency. Against the backdrop of heightened prospects for an escalation of the debt crisis and a destabilisation of the euro area, on 25 March 2011 the European Council adopted a package of measures to enhance the coordination of economic policies in the euro area. The *Euro-Plus Pact*[9] involves a commitment by the participating countries to put forward specific measures that they will implement within twelve months, based on indicators and principles enshrined in the pact. Improving the sustainability of public finances as one of the four objectives of the Euro-Plus Pact[10] calls for a consistent implementation of the Stability and Growth Pact coupled with reforms to improve the sustainability of pensions, health care and social benefits. These reforms should involve aligning the pension system to demographic trends (e.g. raising the retirement age in line with life expectancy or increasing employment), limiting early retirement and using targeted incentives to employ older workers (in particular in the age group above 55). Moreover, the pact determines that participating countries commit to translating EU fiscal rules, as set out in the Stability and Growth Pact, into national legislation; Member States will retain the choice of the specific national legal vehicle to be used, provided that it has a sufficiently strong binding condition and a durable nature (e.g. in the constitution or a framework law). As part of the implementation of the new European strategy, EU2020, and the broader coordination of economic policies across the EU, *changes in economic governance were proposed introducing the European Semester* and closer *ex ante* coordination of macroeconomic and structural policies. In this framework, the priorities include re-establishing solid public finances and long-term fiscal sustainability, reducing unemployment with labour market reforms, and embarking on efforts to boost economic growth. Measures to implement these priorities will be presented by the participating countries in stability (convergence) programmes and national reform programmes on the basis of which the Commission prepares draft opinions and recommendations to be adopted by the European Council early enough so that governments may still include them in the preparation of their budget documents. For fiscal policy, the countries must prepare multi-year programmes for consolidation as part of the abovementioned programmes, laying out specific deficit, revenue and expenditure targets, a strategy for meeting the targets and a timeline for implementation. Implementation of the European Semester began in 2011; by the middle of April, Member States submitted their programmes to the European Commission, which will assess them by mid-year.

States become legally bound to provide their contributions to subscribed capital. The ESM's lending capacity will be checked on a regular basis at least every five years. The ESM will attempt to expand its lending capacity by including the IMF in its financial aid operations; occasionally, Member States outside the euro area will be allowed to participate as well.

[9] Euro area countries have been joined by Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania.

[10] The other three are fostering competitiveness, promoting employment and enhancing financial stability.

2. Budget aggregates of the general government sector (ESA-95) in 2010

The general government deficit dropped slightly in 2010, but it remained at a high level. The budget deficit surged in 2009 (by 4.2 p.p. to 6% of GDP) as the already high level of expenditure jumped in relative terms (by 4.9 p.p. of GDP) due to the economic and financial crisis. At the same time, revenue inched up by 0.8 p.p. in relative terms despite a nominal drop. The general government deficit for 2010 is estimated at 5.6% of GDP, down 0.4 p.p. on 2009. General government revenue edged higher in relative terms, while expenditure inched lower. In 2010, expenditure growth was slower (1.8%) than in the year before (5.4%), when the surge was driven by the effect of automatic stabilisers, the wage reform and stimulus measures, but the marginally faster growth in revenue (2.6%) was not enough to substantially reduce the deficit that had been generated earlier. Last year's deficit would have been even higher had the government not intervened in the face of the widening gap between revenue and expenditure with a Supplementary Budget in July 2010, which adjusted expenditure to lower revenue (in particular spending on investments, investment transfers and wages[11]).

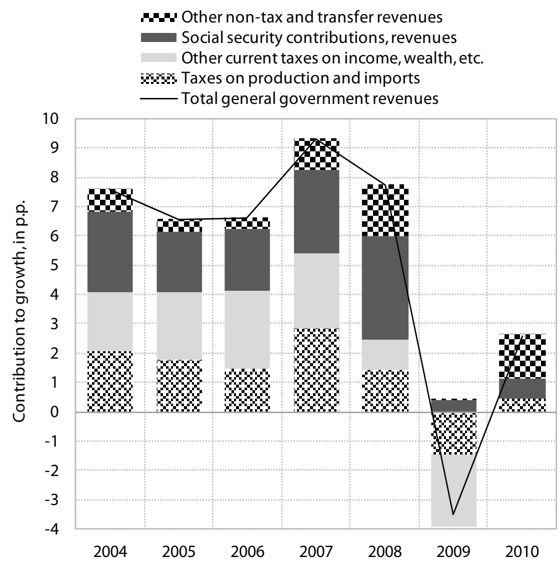
Table 3: **Revenue, expenditure and deficit of the general government sector, as % of GDP**

	2005	2006	2007	2008	2009	2010
Total general government revenue	43.8	43.2	42.4	42.3	43.1	43.4
Total general government expenditure	45.3	44.6	42.5	44.1	49.1	49.0
Net lending (+) / net borrowing (-)	-1.5	-1.4	-0.1	-1.8	-6.0	-5.6

Source: SORS, Main aggregates of the general government, April 2011; calculations by IMAD.

The revenue-to-GDP ratio rose by 0.3 p.p. last year, mostly on account of transfers and other revenue. Tax revenue had a smaller contribution in relative terms. Broken down by key tax categories, the share of revenue from social security contributions remained level over the year before, while the share of taxes on production and imports dropped marginally. Among the latter, excise revenue rose slightly in nominal terms due to higher excise duties in spite of a lower volume of sales of excise products, whereas value added tax receipts increased only marginally. Current income and property taxes dropped by 0.2 p.p. after the completed assessment of personal income tax and corporate income tax following the release of business results (the corporate income tax rate was lower and tax relief higher for both sources).

Figure 4: **Contribution to the growth of general government revenue, 2004–2010, in p.p.**



Source: SORS, Main aggregates of the general government, April 2011; calculations by IMAD.

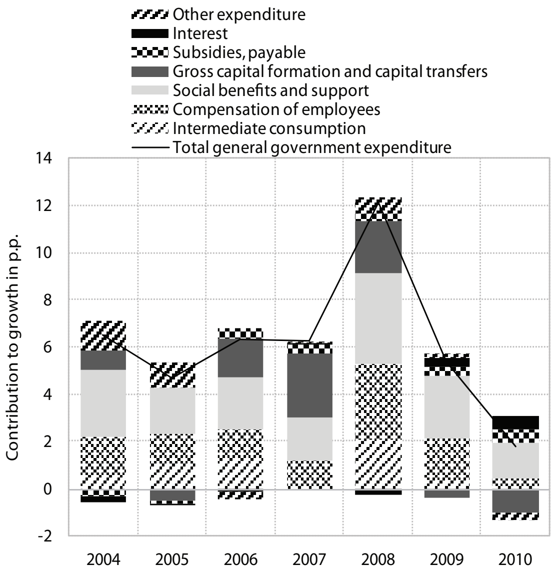
Relative general government expenditure remained virtually level over the year before in 2010 (49% of GDP). Growth was buoyed by higher social benefits in cash and kind, subsidies and interest expenditure, whereas investment and investment transfers were the main factors pushing expenditure down. Social benefits in cash and kind rose by 0.4 p.p., mainly due to the rising number of the unemployed and socially disadvantaged, and to a lesser extent due to the adjustment to inflation, which was limited with an emergency law. The continued implementation of stimulus measures increased expenditure on subsidies as a share of GDP by 0.3 p.p. Interest expenditure was up 0.3 p.p. as government borrowing rose. Compensation of employees remained level over 2009 in relative terms on the back of a postponement of implementation of the public sector wage reform (payment of the third and fourth quarter of the funds for the elimination of wage disparities) and a restrictive wage policy in the public sector, even as the number of employees in the general government sector rose by 1.5%.[12] Expenditure on intermediate

[11] Under the Agreement on Measures Regarding Public-Sector Salaries and Other Compensation for 2011 and 2012, two quarters of the payment for the elimination of wage disparities were deferred (see Challenges in the Labour Market chapter).

[12] In the administrative part of the public administration (i.e. the civilian bodies of the public administration), the number of employees dropped in 2010 (-2.5% or -2.3% excluding the reposting of civil servants to the newly established Capital Assets Management Agency of the Republic of Slovenia).

consumption remained at the 2009 level as well. Only the share of investments and investment transfers (by 0.6 p.p.) and other expenditure (by 0.3 p.p.) dropped last year.

Figure 5: **Contribution to the growth of general government expenditure, 2004–2010, in p.p.**



Source: SORS, Main aggregates of the general government, April 2011; calculations by IMAD.

The general government deficit was generated primarily at the central government level, much as it was in the years before, but the deficits of the local government and social security funds, although still low, also increased in the past two years. In 2010, the central government accounted for just over 85% of the total deficit.

Table 4: **General government deficit, surplus by levels, as a % of GDP**

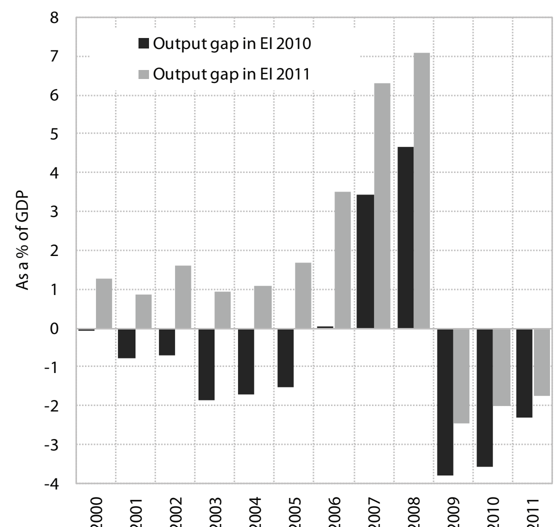
	2005	2006	2007	2008	2009	2010
General government deficit (-), surplus (+)	-1.5	-1.4	-0.1	-1.8	-6.0	-5.6
Central government	-2.2	-1.4	-0.1	-1.2	-5.0	-4.8
Local government	0.0	-0.1	-0.1	-0.6	-0.5	-0.4
Social security funds	0.8	0.1	0.2	0.0	-0.4	-0.4

Source: SORS, Main aggregates of the general government, April 2011; calculations by IMAD.

2.1. Cyclically adjusted general government balance

The cyclically adjusted general government balance[13] is one of the tools for assessing the orientation and appropriateness of fiscal policy, but it should be used with caution in economic policy-making due to methodological changes, changing estimates of potential output and the impact of revisions of data for previous years. It provides an additional insight into the impact of past fiscal policy measures, which can contribute to *ex post* estimates of fiscal policy orientation and the determination of causes of imbalances in the past. But in analysing the cyclically adjusted balance, caution is advised in interpreting the fiscal position estimate and using it as a basis for economic policy in view of the volatility of estimates of potential growth and the output gap (see Figures 6 and 7). Changes in forecasts, methodological changes,[14] and revisions of growth estimates and basic aggregates of the general government with

Figure 6: **Comparison of output gap estimates in 2010 and 2011**



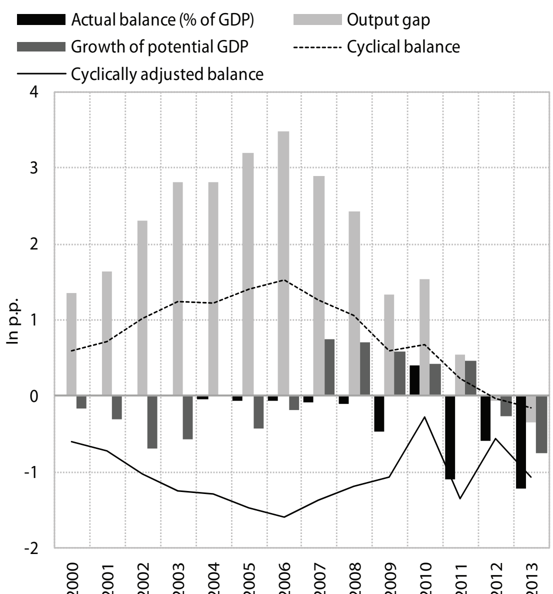
Source: IMAD.

[13] The cyclically adjusted deficit is calculated with the production function method. It includes: potential output estimated after the release by SORS of GDP growth data for 2010 and taking into account the projections in the Spring Forecast 2011 (IMAD), and the latest realisation of general government revenue and expenditure.

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

the attendant changes in output gap estimates, can substantially alter the *ex post* assessment of the fiscal condition. This may lead to a situation where fiscal policy is assessed *ex post* as counter-cyclical while the next calculation for the same year shows it was cyclical. This is particularly problematic when the cyclically adjusted balance is defined as a medium-term fiscal target (see Long-term sustainability of public finances, Section 5, and Consolidation of public finances – estimate and challenges, Section 6).

Figure 7: **Change in estimates of cyclical and cyclically adjusted balance in 2011 relative to 2010, in p.p.**



Source: SORS, Economic Issues 2010 (IMAD), Stability Programme 2011, IMAD calculations.

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

	Actual balance 1	Cyclical balance 2	Cyclically adjusted balance 3=1-2	Change in cyclically adjusted balance[1]
2000	-3.7	0.6	-4.3	-0.6
2001	-4.0	0.4	-4.4	-0.1
2002	-2.5	0.4	-3.2	1.2
2003	-2.7	0.4	-3.1	0.1
2004	-2.3	0.4	-2.7	0.4
2005	-1.5	0.8	-2.2	0.5
2006	-1.4	1.6	-2.9	-0.7
2007	-0.1	2.8	-2.9	0.1
2008	-1.8	3.1	-4.9	-2.1
2009	-6.0	-1.1	-4.9	0.0
2010	-5.6	-0.9	-4.7	0.1
2011	-5.5	-0.8	-4.7	-0.1

Source: SI-Sat data portal – Economy – National accounts – Main aggregates of the general government (SORS), 2011 for the actual balance; cyclical components - IMAD calculations. Note: [1]Positive change means an improvement of the balance. The Figures do not always add up because they are rounded.

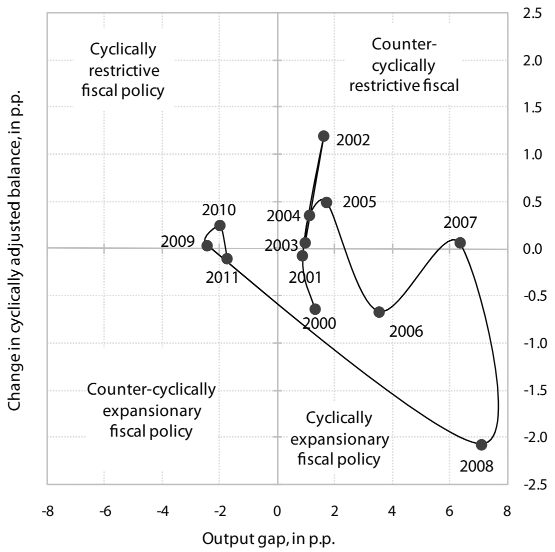
The latest calculations show that the structural component has been high since as far back as 2008. The deficit increase in 2008 was clearly structural, with our estimate suggesting that the cyclically adjusted balance[15] deteriorated by 2.0 p.p. With the downturn in 2009, the cyclically adjusted balance[16] experienced a severe deterioration (by 4.2 p.p. of GDP), which affected the state of public finances that year, while the cyclically adjusted deficit remained high. In 2010, the actual deficit narrowed by 0.4 p.p. of GDP, with equal contributions from changes in the cyclical and the cyclically adjusted deficit. The cyclically adjusted deficit, which stood at 4.7% of GDP according to our estimate, thus remains the key factor behind the fiscal imbalance for the third year running and shows no signs of improvement. These calculations thus suggest that the current precarious state of public finances is to a significant degree a vestige of fiscal policy in the year preceding the crisis, while the financial and economic crisis only made matters worse.

A comparison of the dynamics of the cyclically adjusted deficit and the output gap shows whether fiscal policy is cyclical or counter-cyclical. Changes of the cyclically adjusted balance in consecutive years indicate the orientation of fiscal policy, i.e. the fiscal impulse. By comparing the change in the cyclically adjusted balance and output gap between individual years, which indicates fluctuations in the economic cycle, it is possible to assess the orientation of fiscal policy, i.e. the fiscal position. A positive fiscal impulse, for example, means an increase of the cyclically adjusted deficit in the current year compared to the year before. The varying distances of individual points from the axes shows the intensity of fiscal policy. In Figure 8, there are four distinct quadrants of changes in fiscal impulse and output gap that determine the fiscal position. Fiscal policy is counter-cyclical if the combination of both parameters lies in the first or third quadrant. This means that when economic growth falls below its potential, fiscal policy becomes expansionary; when actual growth exceeds potential GDP growth, it responds restrictively. Fiscal policy is cyclical if the combination of both parameters lies in the second or fourth quadrant. This means that when economic growth falls below potential, fiscal policy

[15] The cyclically adjusted or structural balance shows what kind of fiscal position could be achieved simply with the operation of fiscal policy measures, i.e. without the influence of cyclical factors.

[16] The cyclical balance indicates to what extent (and in which direction) macroeconomic conditions have affected the fiscal position. It is calculated with the production function method based on potential GDP growth estimated after the publication by SORS of GDP growth data for 2008 and taking into account economic growth projections in the Spring Forecast of Economic Trends 2011 (IMAD) and the latest realisation of general government revenue and expenditure.

Figure 8: **Cyclical orientation of fiscal policy**



Source: SI-STAT data portal – Economy – National accounts – Main aggregates of the general government (SORS), 2011; Spring Forecast 2011 (IMAD); cyclical components - IMAD calculations.

responds restrictively; when actual growth exceeds potential GDP growth, it becomes expansionary. A cyclical orientation means that fiscal policy does not allow for automatic stabilisers to operate, the result being that, for example, expenditure fluctuates not as planned but in accordance with changes in economic growth. On the revenue side, this means that when economic growth is higher than initially planned, cyclical budget revenue is used to finance tax cuts and increased expenditure, not to curb the deficit.

This year's calculations show that fiscal policy has been fairly neutral since 2009 following a cyclical bent in the period preceding the crisis. A comparison of the dynamics of the cyclically adjusted balance and the output gap[17] shows that fiscal policy was very cyclical and expansionary in 2008; however, the economy and, by extension, public finances, had already started to deteriorate in the final months of 2008 as the economic and financial crisis escalated, whereas the output gap was as yet unaffected. The calculated fiscal position in 2008 does not take into account the fact that the revenue shortfall was caused by a slowdown in economic activity, which per se already amounts to counter-cyclical action. In addition to these impacts, which are inherently more cyclical than structural, the structural component of the deficit was probably buoyed by measures adopted in 2007 and 2008. These include higher outlays on investment and social transfers,[18] and higher wages following the implementation of the new wage system in the public sector which, coupled with more hiring, increased expenditure. On the other hand, tax changes were being put in place that reduced budget revenue: the general personal income tax allowance was increased, whereas the payroll tax and corporate income tax rates were cut. In 2009, when the economy contracted sharply and the output gap was negative, fiscal policy was counter-cyclical as the structurally adjusted deficit remained high, but we estimate that it was not expansionary; the same holds for 2010. Despite reservations as to the calculations of changes in the structurally adjusted deficit, we estimate that fiscal policy not having been expansionary in the crisis period is partially a consequence of the limitations of public finances. It also has to do with the relative inefficiency of large-scale measures in an open economy. The orientation of fiscal policy can also be inferred from a simple comparison of deficit and debt. Slovenia's general government debt rose by 16.1% of GDP in 2009 and 2010, whereas the deficit stood at 6.0% and 5.6% of GDP respectively. Higher borrowing relative to the need to finance deficit spending (see General government debt, Section 4), coupled with a high output gap in both years, suggests that fiscal policy was somewhat expansionary.

[17] The output gap is estimated based on a changed methodology in the production function. Instead of the Hodrick-Prescott filter (see Economic Issues 2010), we are using the bivariate Kalman filter to smooth out the total factor productivity.

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

3. Financial flows between Slovenia and the EU budget

Ministry of Finance data show that the inflow of EU funds to the Slovenian budget totalled EUR 326.4 m in 2010, the highest it has been since Slovenia joined the EU. EU funds are not absorbed at an equal pace year-on-year or during the year, the pace depends on the quality of projects, the ability of beneficiaries to secure their own funds and, ultimately, the preparation and implementation of tenders and the speed of competent ministries, which prepare documentation for refunds to the national budget after the project is completed. Nevertheless, the net position to the EU budget in 2009 and 2010 indicates an improved capacity to draw EU funds, which is partially also a result of measures to speed up the absorption of EU funds adopted at national and EU levels at the end of 2008 and in early 2009.

Slovenia has been a net recipient of EU funds since 2004. The net position of its national budget to the EU budget was positive in five years and negative in two. In the first financial perspective (2000–2007) Slovenia was among the most successful new Member States in the drawing of EU funds, having absorbed nearly 70% of eligible funds to the end of 2006. In 2007 and 2008, the net position of the national budget to the EU budget was negative. In 2007, this was the consequence of poor drawing of EU funds (59.7%), in particular cohesion policy funds[19] (structural funds 24.4%, Cohesion Fund 31.7%), where there was also a delay in the drawing of funds from the new financial perspective.[20] At the same time, payments to the EU budget in 2007 were higher than expected, particularly on the back of higher payments from traditional own resources.[21] In 2008, the drawing of structural policy funds was again very modest (12.3%), while at the same time the drawing of internal policy funds dropped sharply after Slovenia joined the Schengen Area. The drawing of cohesion policy funds, in contrast, was better than expected as the bulk of these funds (55%) had been allocated under the previous financial perspective. The main reasons for the relatively paltry drawing of EU funds in these years include complex procedures for the approval of funds and administrative obstacles inherent to the conservative system of drawing and monitoring of EU funds in Slovenia. With the concurrent implementation of two financial perspectives and the time limit on the drawing of funds from the first financial perspective, one reason why the drawing of funds was poor probably lies in the new conditions, criteria and rules of cohesion policy funds in the new financial perspective (2007–2013), which required some time for adjustment. Moreover, when the financial and economic crisis hit towards the end of 2008, it became difficult for beneficiaries to secure their own funds for the financing of projects.

Despite the negative net position of the national budget to the EU budget in 2007 and 2008, according to European Commission data (Table 7), Slovenia had a positive position overall in the period 2004–2009 taking into account all payments. Apart from

Tabela 6: **Planned and realised revenue and expenditure flows between the EU budget and the Slovenian budget, 2004–2010**

Year of realisation	Revenue, In EUR m			Expenditure, In EUR m			Net position
	Planned	Realised	Percentage of realisation	Planned	Realised	Percentage of realisation	
2004	335.3	183.8	54.8	187.9	170.0	90.2	13.8
2005	483.7	302.4	62.5	305.2	285.6	93.6	16.8
2006	449.6	348.4	77.5	315.0	287.9	91.4	60.5
2007	582.1	347.2	59.7	317.1	355.9	112.2	-8.7
2008	783.0	363.2	46.4	375.3	427.9	114.0	-64.7
2009	814.0	594.9	73.1	452.0	439.3	97.2	155.6
2010	1.037.8	723.2	69.7	412.8	396.8	96.1	326.4
Total	4.485.5	2.862.1	63.8	2.365.3	2.363.4	99.2	499.7

Source: Ministry of Finance, Department of cooperation with the EU budget.

[19] In the new financial perspective (2007–2013) cohesion policy funds are drawn from structural funds (European Regional Development Fund and European Social Fund) and the Cohesion Fund.
[20] In 2007, the new (second-in-a-row) financial perspective as the underlying framework for EU budgetary planning took effect for a seven-year programming period (2007–2013). However, the drawing of funds from the second financial perspective only started in 2008.
[21] Traditional own resources (payments originating from customs duties, import duties and special taxes on the import of agricultural products and foodstuffs) are treated as EU budget revenues; the Member States retain a quarter of the funds as reimbursement for the costs of collection.

Table 7: **Net position of the Republic of Slovenia with respect to the EU budget, 2004–2009**[22]

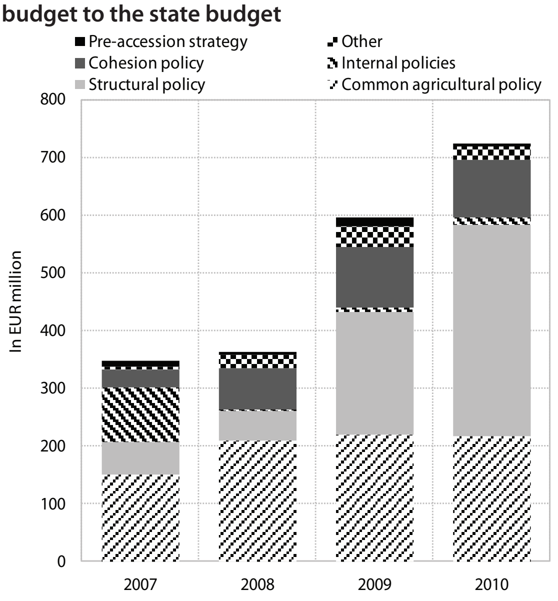
In EUR m	2004	2005	2006	2007	2008	2009
Total funds received from the EU budget	282.0	366.2	406.1	390.1	456.4	616.3
Total funds payed to the EU budget	170.4	274.4	279.1	359.4	408.5	427.7
Net position – accounting records*	111.6	91.8	127.0	30.7	47.9	188.6
Net position** – (operating budgetary balance)	109.7	101.5	142.7	88.5	113.8	261.6

Source: EU Budget 2009 Financial Report.
Notes: * Net position based on the accounting definition is calculated as the difference between total receipts and total payments. ** Net position is calculated as the difference between allocated and contributed funds, excluding administrative expenditure, and taking into account adjusted national contributions based on the UK rebate.

the revenues of the national budget, these balances also include payments from the EU budget to final beneficiaries in the Republic of Slovenia based on centralised European Commission tenders (public institutes, municipalities, companies, individuals). Differences in data on the net position of the national budget to the EU budget are also caused by the delay in the use of funds and refunds to the national budget, even though the refunds are carried out as per project phases. These delays occur due to delays in the preparation of expense claims based on which the certification authority approves refunds to the national budget.

Improvement in the net position of the national budget to the EU budget continued at an accelerated pace in 2009, with funds under the common agricultural policy and cohesion policy accounting for the bulk of receipts. After two lacklustre years, 73.1% of planned funds from the EU budget were drawn in 2009; the net position to the EU budget (EUR 155 m) exceeded the heretofore highest sum achieved in 2006 (EUR 60.5 m). The drawing of cohesion policy funds in particular surged (96.5% of the planned amount), while only half of the available structural funds were drawn. In 2010, revenue from the EU budget increased further to reach the highest level thus far (EUR 723.2 m), with 70% of the budgeted funds being realised. The bulk of the refunds originated in the second financial perspective, as the drawing of funds from the previous financial perspective ended in 2010. The drawing of agricultural and fisheries policy funds was very successful in 2010 (84%), much as it was in the previous years. Over half (56%) of the agricultural policy receipts was refunded to the national budget from the rural development programme EAGGF[23] (guarantee section) and EAFRD.[24] Slovenia was more successful in drawing structural (68.6%) than cohesion funds (48.7%). Just below 68% of structural funds were refunded from the European Regional Development Fund (ERDF), of which 95% was allocated for the Operational Programme for Strengthening Regional Development Potentials (OP SRDP). All the funds (EUR 94 m) from the European Social Fund (ESF), which accounted for over a quarter of structural funds, were spent on the implementation of the Operational Programme for Human Resources Development 2007–2013 (OP HRD). Cohesion funds were allocated in their entirety last year for the implementation of the Operational Programme of Environmental and Transport Infrastructure Development (OP ETID). Data from the Government Office for Local Self-Government and Regional Policy show that the use of all planned cohesion policy funds was approved in 2010 (Table 8), but paid funds followed the signing of contracts with a delay. Submission of expense claims only speeded up towards the end of the year, which contributed to the improvement of the net position to the EU budget. For the whole year, expense claims amounted to 78.8% of payments, of which 80% of the claims were certified and refunded to the state budget. Despite the significant progress in the submission and certification of claims in 2010 compared to 2009,

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



Source: Ministry of Finance.
Note: The relatively high drawing of internal policy funds in 2007 is attributed to Slovenia's accession to the Schengen Area.

[22] Data for 2010 will be released in the second half of 2011.

[23] EAGGF – European Agricultural Guidance and Guarantee Fund.

[24] EAFRD – European Agricultural Fund for Rural Development.

Table 8: **Absorption of cohesion policy funds under the 2007–2013 financial perspective (as of 31.12.2010)**

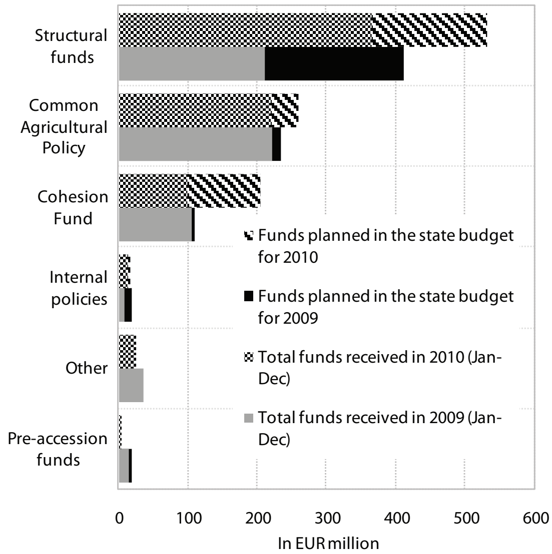
	In EUR m				% with regard to eligibility 2007–2010			
	OP ETID**	**OP SRDP****	**OP HRD****	**Total all OPs**	**OP ETID**	**OP SRDP**	**OP HRD**	**Total all OPs**
Eligibility 2007–2010	605.4	1,179.0	492.0	2,341.0				
Confirmed operations	742.4	1,067.3	484.8	2,294.5	122.6	90.5	98.5	98.0
Signed contracts	475.0	1,067.3	478.7	2,021.0	70.9	90.5	97.3	86.3
Executed payments	242.1	729.2	185.7	1,157.0	36.1	61.8	37.7	49.4
Submitted expense claims	218.0	560.2	133.1	911.3	32.5	47.5	27.1	38.9
Certified expense claims	210.4	413.5	107.9	731.8	31.4	35.1	21.9	31.3

Source: Government Office for Local Self-Government and Regional Policy; IMAD calculations.
Note: * The data refer to the EU portion of funds; **OP ETID - Operational Programme of Environmental and Transport Infrastructure Development, OP SRDP - Operational Programme for Strengthening Regional Development Potentials, OP HRD - Operational Programme for Human Resource Development.

substantial delays in refunds to the national budget are still occurring in the Operational Programme for Strengthening Regional Development Potentials and, to a lesser extent, in the Operational Programme for Human Resources Development.

The net position to the EU budget improved in 2009 and 2010 with measures adopted at the national and EU levels to accelerate the absorption of EU funds. At the end of 2008 and beginning of 2009 measures to accelerate the absorption of cohesion policy funds (where the biggest delays in refunds to the national budget occur) were adopted at EU and national levels. As part of the EERP[25] a measure was adopted at EU level to speed up the allocation of funds to Member States in the amount of EUR 6.3 bn from social and regional funds. At the national level, amendments to the Public Finances Act made it possible to reallocate funds from projects whose implementation is uncertain to projects that could be carried out in the current year. Improvements and simplifications in the implementation of cohesion policy include the introduction of advance payments with the purpose of advancing funds, which yielded positive results in 2009 and 2010, when companies faced liquidity problems.

Figure 10: **Planned and absorbed funds from the EU budget, 2009 and 2010**



Source: Ministry of Finance, IMAD calculations.

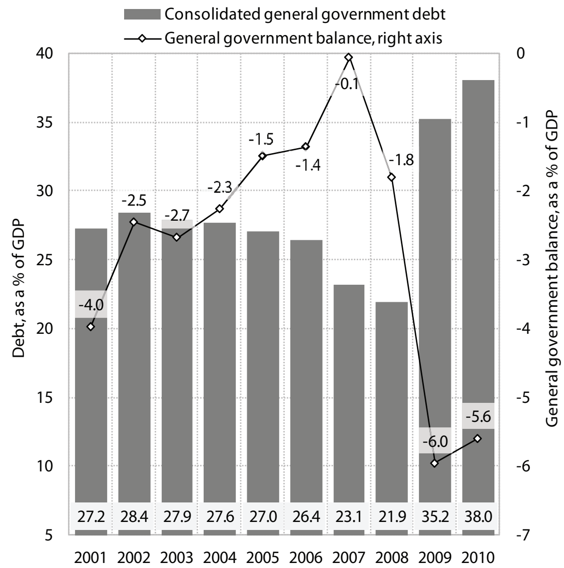
[25] EERP: European Economic Recovery Plan.

4. General government debt

The general government debt was estimated at 38.0% of GDP[26] at the end of 2010. Debt decreased gradually after 2002, touching a low of 21.9% of GDP in 2008. With the general government deficit in this period relatively low, the reduction of debt as a share of GDP was both a consequence of debt portfolio restructuring (in particular the replacement of inflation-indexed debt instruments and debt repayment) and also a result of fairly high GDP growth. In 2009, debt surged by 12.1 p.p. as the general government deficit rose, and the government embarked on front-loaded borrowing to finance the deficit in 2010 (these funds were initially put down as bank deposits). In 2010, debt rose by 3.5 p.p., mainly due to the financing of the deficit (5.6% of GDP). Debt increased by less than the deficit due to the use of funds obtained with front-loaded borrowing in 2009. Nevertheless, the relative debt increase over the two years (16.1 p.p.) is higher than the deficit increase in the same period (6.0% and 5.6% of GDP). The debt of the central government accounts for the bulk of total (non-consolidated) general government debt (96% at the end of 2010). Non-consolidated debt at the local level, although nearly doubling over the past three years, remains fairly low.[27]

In 2010, Slovenia continued to borrow, mainly in the form of long-term securities. In the first quarter of 2010, two bonds were issued, a EUR 1 bn 5-year

Figure 11: **General government debt and deficit**



Source: Main Aggregates of the General Government (SORS), 2011.

Eurobond and a EUR 1.5 bn 10-year Eurobond. The debt of the central government was largely long-term (97% at the end of 2009)[28] in line with the strategy of issuing 10-year fixed-interest coupon Eurobonds. The debt maturity profile of the central government is fairly equally distributed, without major concentrations in any individual year.

Publicly guaranteed debt also continued to rise last year. Following a significant increase in 2009,[29] the growth of publicly guaranteed debt continued last year, albeit at a more moderate pace; at the end of

Table 9: **Balance of consolidated general government debt by sub-sectors, Slovenia, 2000–2010**

In EUR m		2000	2006	2007	2008	2009	2010
1	Total general government[1]	4,886	8,204	7,981	8,180	12,449	13,704
1.1	Central government	4,804	8,118	7,904	8,091	12,110	13,171
1.2	Local government	60	236	256	354	523	626
1.3	Social security funds	97	3	3	3	2	52
1.4	Consolidated debt among sub-sectors	-74	-153	-182	-268	-187	-146
As a % of GDP							
1	Total general government[1]	26.4	26.4	23.1	21.9	35.2	38.0
1.1	Central government	26	26.1	22.9	21.7	34.2	36.5
1.2	Local government	0.3	0.8	0.7	0.9	1.5	1.7
1.3	Social security funds	0.5	0	0	0	0	0.1
1.4	Consolidated debt among sub-sectors	*-0.4*	*-0.5*	*-0.5*	*-0.7*	*-0.5*	*-0.4*

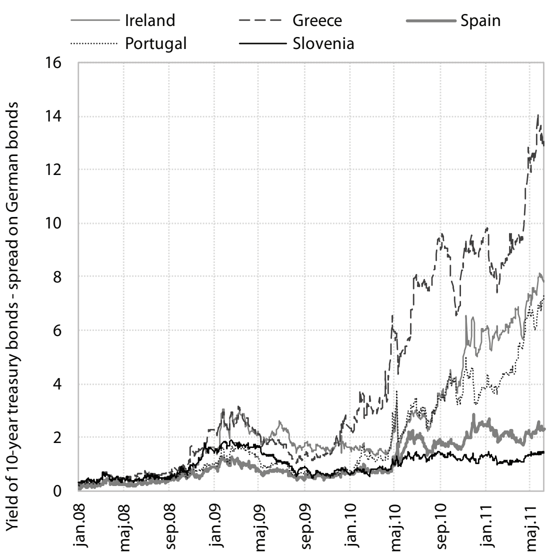
Source: General government debt, Slovenia, 1994–2010 (SORS), 2011.
Note: [1]Data on debt is consolidated (reduced by amounts due among general government units).

[26] SORS (March 2011).
[27] Borrowing by local communities is limited with the Financing of Municipalities Act, which stipulates that a local community's debt may not exceed 20% of the previous year's revenue while expenditure on debt servicing may not exceed 5% of the previous year's revenue.
[28] Report on the Management of the Public Debt of the Republic of Slovenia for 2009 (July 2010).
[29] Mainly as a result of guarantees for loans in the amount of EUR 2 bn that the state granted to domestic banks.

the year, it totalled EUR 7.7 bn or 21.5% of GDP. In the last two years, publicly guaranteed debt as a share of GDP rose by 9 p.p. and general government debt by just over 15 p.p. Even though state guarantees do not directly increase general government debt until they are called up, their scope and the estimate of the probability of them being called up can affect how a country is perceived by financial markets, and make borrowing more expensive by widening spreads.

The yield spread of Slovenian bonds on the German reference bond is wider than before the crisis, but Slovenia remains within the group of countries that have retained relatively stable yields. Following a drop in the yield of the 10-year treasury bond below 4% at the end of 2009, which continued into the first eleven months of 2010, the yield rose again in December, averaging 4.11% that month. The spread of 10-year bonds on the German reference bonds remained below 100 basis points until April 2010, but this was still wider than in the period before the crisis. As a result of the Greek crisis, the spread widened in the second half of 2010, much as it did for the majority of other euro area countries, and remained at that level until May 2011.

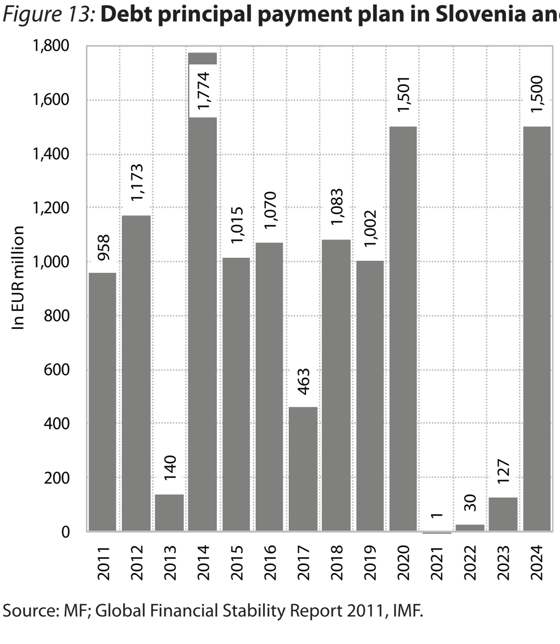
Figure 12: **Spread of 10-year bonds on the reference German bond**

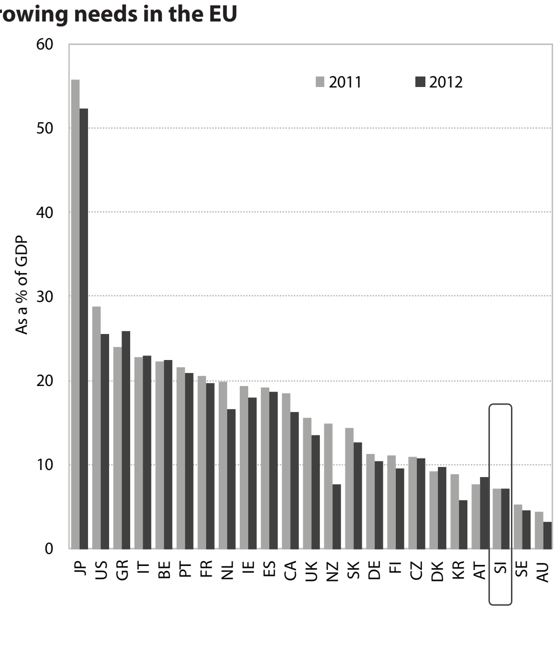


Source: Eurostat.

Slovenia's debt has been rising relatively rapidly, but refinancing needs in the coming years are low compared to the majority of EU countries. The level of general government debt is still well below the euro area average; however, the pace of borrowing has been faster in the past two years (see Fiscal Development and Policy in the EU, Section 1). Forecasts in Stability Programme – Update 2011 suggest that at the end of this year debt will have more than doubled the level reached in 2008. The need for debt refinancing is moderate compared to the majority of euro area countries. Debt maturity is relatively spread out, absent bigger concentrations in any particular year, which means the refinancing risk is equally distributed. Funds for the coverage of refinancing needs in 2011 were secured with bond issues in the first quarter of this year, which will increase the debt faster than the deficit in relative terms during the year.

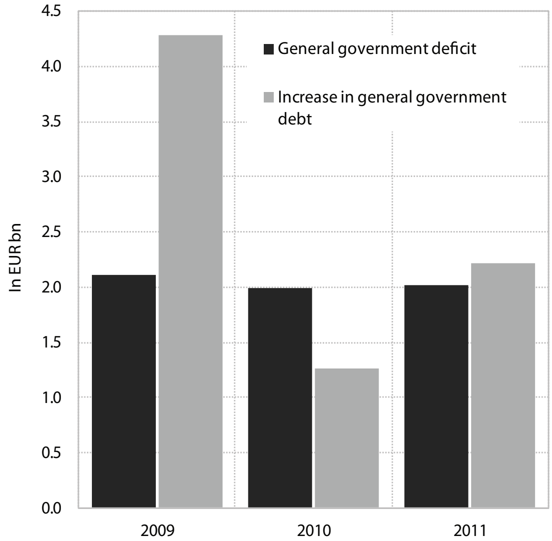
Figure 13: **Debt principal payment plan in Slovenia and borrowing needs in the EU**





Source: MF; Global Financial Stability Report 2011, IMF.

Figure 14: **General government debt and increase in deficit, 2009–2011**



Source: SORS, Stability Programme – Update 2011.

The brisk pace of debt growth in the unstable economic environment of the past two years is exacerbating the risk that the debt will exceed 60% of GDP in case of a renewed economic crisis. Another key risk factor is state guarantees, which already exceed 20% of GDP. Even though Slovenia's general government debt is still relatively low, the brisk pace of borrowing in the past two years is highlighting the risk that in the event of a new crisis, debt may approach the 60% of GDP ceiling prescribed by the Stability and Growth Pact. Guarantees are another factor increasing the risk of a surge in debt. In the event that they are called up (in their entirety), debt would breach the ceiling even at the current level.

Keeping the general government debt at a sustainable level will be a key challenge for fiscal and other economic policies in the coming years. A key factor influencing the level of debt is the implementation of credible economic policy measures underpinning the fiscal consolidation programme. A key to achieving that is the carrying out of structural reforms ensuring the long-term sustainability of public finances; as early as this decade, pressure on ageing-related expenditure will rise considering the expected demographic trends (see Long-term sustainability of public finances, Section 5). There are several other factors that will affect debt growth in the coming years in addition to the direct impact of deficit financing and the refinancing of debt liabilities. As the euro area economies recovered and inflation pressures escalated, the ECB raised the benchmark interest rate in April of this year; further rate hikes are likely, which will raise interest rates on international financial markets and make borrowing more expensive for sovereign and private borrowers. The debt problems of some euro area countries heighten the probability of higher bond yields (spillover effect in the entire euro area), which could affect the price of Slovenia's borrowing in the coming years. This could happen notwithstanding the relatively low debt level and even in the event that Slovenia's rating does not change and the spread on German reference bonds remains unchanged. However, if Slovenia's credit rating is lowered due to slow fiscal consolidation and an erosion of financial markets' confidence in the country's commitment to push through with the consolidation measures, it will be more difficult to secure financing for deficit borrowing and the refinancing of debt liabilities. Moreover, more expensive borrowing would hurt the quality of public finances, as growing expenditure on interest would crowd out the more flexible development expenditure, which could weaken the development role of public finances. Preserving the current rating is therefore paramount, as it affects not only the costs of treasury borrowing but has ramifications for the entire economy. Insufficient action in the consolidation of public finances, which would lead to a deterioration of the perception of Slovenia's standing by the financial markets, would restrict access to financing not only for the state but also for the private sector, which would undermine competitiveness and hamper potential growth.

5. Long-term sustainability of public finances

In the long term Slovenia's fiscal position depends crucially on the impact of projected demographic changes, which indicate a very unfavourable trend in a scenario in which social protection systems are left intact. Population projections made in 2008[30] confirmed that the populations of all EU countries – Slovenia is among four countries identified at greatest risk – are ageing fast. As a result of demographic change alone, there will be increasing demand for pensions, health and social care. In fiscal terms, this means that implicit government liabilities are growing. Given the concurrent drop in the share of the working-age population, it is unrealistic, given the present social protection systems, to expect sufficient funding from contributions to cover rising expenditure.

Absent change in policies, ageing-related expenditure will start growing at an accelerated pace as early as this decade, which will lead to a surge in government borrowing. Slovenia is among the EU Member States with the highest projected ageing-related expenditure according to the European Commission's estimate.[31] Calculations of ageing-related expenditure using a commonly agreed methodology suggest that expenditure as a share of GDP will surge in the next twelve years in the absence of policy changes. In 2023, pension expenditure is projected to rise by 1 p.p. from the present level of 11.2% of GDP, whereupon it would rise by a percentage point on average every five years to reach 20.2% of GDP in 2060. Were this trend to persist, borrowing would rise sharply. Even though long-term, these contingent liabilities are already affecting the shaping of fiscal policy measures, Slovenia's standing on financial markets and borrowing costs, as rating agencies have been considering these factors in their sovereign credit ratings to an ever higher degree (in December 2010 Standard&Poor's placed Slovenia's credit rating on a negative outlook taking into account the uncertainty concerning the implementation of the pension reform; see also Fitch Report 2010).

Table 11: **Requisite adjustment of public finances due to long-term contingent liabilities (absent policy changes)**

	Requisite adjustment in the period 2010–2030 incl. ageing-related expenditure
Greece	14,0
Slovenia	7,7
Ireland	14,4
Spain	10,3
Belgium	8,7
Finland	6,6
Czech Rep.	4,4
U.K.	13,5
Netherlands	9,5
Germany	4,4
Austria	6,7
Slovakia	8,9
Sweden	0,6
France	8,4
Portugal	10,6
Denmark	6,2
Italy	4,6
Estonia	-3,1

Source: Fiscal Monitor 2011, IMF, 2011

EU Member States will respond to the challenges of ageing with measures in three areas: by reforming the pension and health care systems, reducing the level of general government debt and increasing employment and productivity. With a view to making this approach operational, the procedural rules for the preparation of Stability Programmes, in which governments also need to lay out measures to ensure the long-term sustainability of public finances, were changed. The changed rules determine that the European Commission will estimate to what extent Member States must front-load funds for the

Table 10: **Fiscal effects of the various systems of pension and disability insurance, as a % of GDP**

	2009	2011	2013	2015	2017	2019	2021	2025	2030	2040	2050	2060
ZPPIZ-1 – current system	11.2	11.2	11.4	11.6	11.7	11.9	12.1	13.0	14.4	17.5	19.7	20.2
ZPIZ -2 – original government proposal	11.2	11.1	11.0	10.7	10.4	10.2	10.1	10.6	11.8	14.6	16.6	17.0
ZPIZ-2 – adopted but not yet valid system	11.2	11.1	11.2	10.9	10.7	10.6	10.6	11.3	12.7	15.6	17.7	18.2

Source: Dodatne ocene učinkov predlagane pokojninske zakonodaje (Additional Estimates of the Effects of Proposed Pension Legislation), Mitja Čok, Jože Sambt, Boris Majcen, IER, November 2010.
Note: The figure for 2009 represents all pensions as a share of GDP (11.2%): social security pensions (old-age, disability, family and widow's pensions), farmer pensions, veteran pensions, pensions claimed in other republics of the former SFRY, pensions transferred to other republics of the former SFRY, pensions transferred abroad, annual pension allowance, other pensions and state pensions. The figure differs from ZPIZ data (10.91% of GDP in 2009), which includes pensions as reported by ZPIZ in its statistical reports.

[30] Eurostat: Population Projections EUROPOP2008.
[31] The estimates were made in the framework of the Working Group on Ageing Populations and Sustainability at the Economic Policy Committee (2008).

financing of long-term implicit liabilities, taking into account the link between the medium-term fiscal target (structural balance of public finances) and the expected dynamics of debt growth. According to the calculations, due to its high implicit liabilities, Slovenia will have to set an ambitious medium-term fiscal objective of a structural surplus of 0.7% of GDP, significantly above the medium-term fiscal target that had been set for Slovenia before (a structural deficit of 1% of GDP). Additionally, Slovenia must precisely define the measures it will undertake to achieve this objective in the three aforementioned areas. Analysis of the current achievement of medium-term fiscal targets shows that the implementation estimate is strongly affected by the fact that it is based on *ex post* data. *Ex post* estimates of the structural deficit can differ significantly due to changed estimates of potential growth and output gap, and revisions of estimates of national accounts and the basic aggregates of the general government. This raises questions about the selection of a target calculated in this way as a fundamental basis of economic policy measures. Given the considerable uncertainty due to the variability of the output gap estimate, this means that achieving the structural surplus that calculations suggest is needed to cover implicit liabilities practically requires a constant budget surplus. Notwithstanding concerns regarding the scope of front-loading funding for the coverage of implicit liabilities and the methodology for setting the medium-term fiscal target, the fact remains that Slovenia is among the countries that will face high ageing-related expenditure and heavy pressures on the long-term sustainability of public finances. It is therefore essential to reform the pension and health care systems. If the pension reform is not implemented next year, the state of public finances will shortly dictate further changes that will be even harsher than the currently proposed measures.

Box 1: ***Pension reform proposal***

In December 2010, the National Assembly adopted the new Pension and Disability Insurance Act (ZPIZ-2), which was subsequently rejected in a referendum. The key changes enshrined in ZPIZ-2 that would have a positive impact on public finances included: a) raising the retirement age; b) gradual increase in the number of contribution years used for the calculation of the pensionable earnings; c) adjustment of pensions to wage growth and inflation.

a) Higher retirement age
The retirement age would be raised to: (i) 65 for 15 contribution years for both sexes or (ii) 60 years for 43 contribution years without additionally purchased contribution years for men and 58 years for 43 contribution years without additionally purchased contribution years for women. Early retirement with disincentives would be possible at age 60 with 40 contribution years for men and 38 contribution years for women. These conditions would be phased in over a transitional period set to end in 2025.

b) Increase in the number of contribution years for the calculation of pensionable earnings:
After 2022, the best 30 consecutive years would be used with the option of excluding the three worst years.

c) New method for adjusting pensions
Pensions would be adjusted once a year: until 2015, they would be indexed with a factor comprising 60% of the growth of the average gross wage and 40% inflation, whereupon the index ratio would be 70:30.

Ensuring the long-term sustainability of public finances will require considerable fiscal effort: the key will be to reform the pension system and other social protection systems, and implement measures to raise potential output and create new jobs. Assessment of the medium-term fiscal adjustment needed to ensure the long-term sustainability of public finances and preserve the ability to cover implicit liabilities makes the scope of the requisite fiscal effort clearer. The IMF estimate suggests that with an unchanged pension system, Slovenia would need a cyclically adjusted primary surplus of 7.8% of GDP in the period 2010–2030 if debt is to remain below 60% of GDP, which is in line with the EC estimate of the costs of ageing over an unlimited time horizon. This means that consolidation of public finances would have to be substantially tougher than envisaged in this year's Stability Programme, which would require higher revenue on the back of higher taxes, coupled with significant spending cuts. Implementation of the pension reform would significantly relieve the fiscal effort, but the task would still remain formidable. The proposed reform of the pension system would reduce the medium-term fiscal target from 0.7% of GDP to a structurally balanced budget; hold back the growth in relative expenditure on pensions until about 2025; and finally slow down the eventual rise, with a pension expenditure 2.0% of GDP lower compared to the unchanged policy scenario. The reform of the pension system, even though not as ambitious as the original government proposal (see Table 10), is thus a key element of the long-term sustainability of public finances; even at present, it is crucial to preventing a rating downgrade and the attendant deterioration of borrowing conditions for the state and the private sector on international financial markets. To ensure the long-term sustainability of public finances and thus reduce the need for borrowing, immediate adoption and implementation of structural adjustments in social protection will have to be coupled with structural changes in other areas that will improve competitiveness and raise potential growth rates.

6. Consolidation of public finances – estimate and challenges

6.1. Excessive deficit procedure and the first year of implementation of the Stability Programme – Update 2009

In December 2009, the European Commission launched an excessive deficit procedure against Slovenia, setting 2013 as the deadline for correction of the deficit. In the April 2009 regular Reporting of Government Deficit and Debt Levels, Slovenia estimated the general government deficit at 3.7% of GDP for the year but revised the figure to 5.9% in the second regular report in October 2009. In November 2009, the European Commission initiated pursuant to the EC Treaty an excessive deficit procedure against Slovenia, which is detailed in the revised Stability and Growth Pact of 2005.[32] Based on an assessment of the public finances and the factors for the occurrence of the excessive deficit, the EC prepared a report and set 2013 as the deadline for correction, warning that the wiggle room of Slovenia's fiscal policy is additionally limited due to the challenges of long-term sustainability of public finances and contingent liabilities stemming from state guarantees. Based on the assessment of the fiscal and economic circumstances,[33] the EC set 2013 as the deadline for correction of excessive deficit. It recommended that over the 2010–2013 period, Slovenia ensure an average annual structural budgetary adjustment of ¾% of GDP and specify measures necessary to correct the excessive deficit. The EC stressed that fiscal consolidation must ensure

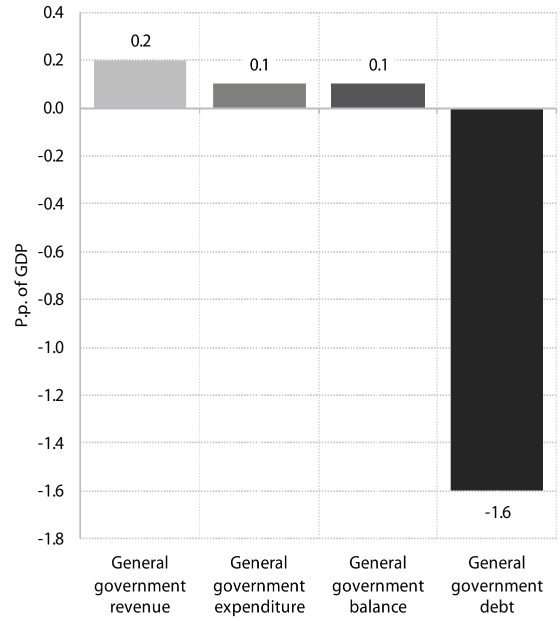
[32] Article 104(3) of the EC Treaty stipulates that whenever a Member State's general government deficit exceeds the 3% of GDP reference value, the EC must prepare a report on the existence of an excessive deficit for the Council, which takes a decision on the matter. When the Council establishes that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

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

permanent improvement of public finances and the quality thereof, and enhance potential GDP growth. In view of the higher-than-budgeted expenditure in the period of 2006–2008 and the reliance on expenditure restraint in the proposed 2010 and 2011 budgets, the EC highlighted that Slovenia needs to improve the enforceable nature of its multi-year budget plans and improve public spending efficiency and effectiveness to make room for enhanced expenditure on research, innovation and human capital formation. At the same time, it needs to raise the participation rates of the young and older people and improve the functioning of the labour market.

The Stability Programme - Update 2009 (SP2009) of January 2010 lays out measures to correct the excessive deficit in accordance with EC recommendations. Under the EC recommendations in the excessive deficit procedure, the objective of fiscal consolidation is to bring the deficit below 3% of GDP in 2013. The Government embarked on fiscal consolidation and excessive deficit correction with expenditure-side measures. According to plans, targeted and temporary measures taken to mitigate the impact of the crisis were to be phased out starting in 2010, with the first effects of consolidation to be visible in 2011. For the entire programming period, it had been envisaged that

Figure 15: **Realisation of general government debt and deficit in 2010 compared to SP2009 forecasts**



Source: SORS, Stability Programme – Update 2009.

consolidation would comprise a phased reduction and restructuring of expenditure, primarily through streamlining, improved efficiency of services rendered by the state and better management with

Box 2: ***EC opinion on the Stability Programme – Update 2009***

In its opinion on SP2009, the EC says that the budgetary strategy for 2010 is broadly consistent with the Council recommendation under Article 126(7) of December 2, 2009. However, the budgetary outcomes could be worse than targeted in the programme and this possibility increases over the programme period. For 2010, it estimates that the projected substantial growth in indirect taxes seems to be only partially substantiated by measures in the programme and on the high side given the subdued outlook for private consumption. Expenditure growth outcomes have exceeded plans in recent years and this situation could reoccur. From 2011 onwards, there is a greater risk of expenditure overruns, according to the EC, as the underlying measures have not yet been fully specified or adopted, while some of them can be expected to be subject to the outcome of negotiations with the social partners. Furthermore, the size of the envisaged retrenchment should be seen against the strong inherent expenditure dynamics and overruns witnessed in recent years, especially in the wage bill and social transfers (including pensions), both of which are planned to make a sizeable contribution to deficit reduction. The EC also recommends that the planned initiatives to enhance public sector efficiency and rationalise the provision of public services and of social protection should be better harmonised. It highlights the necessity of improving oversight of expenditure and the actionability of multi-year budgetary plans, and the efficiency and effectiveness of public spending. Expenditure risks are underpinned by the macroeconomic scenario after 2011, which is assessed as optimistic. Taking into account these risks, it believes the budgetary strategy may not be fully consistent with Council recommendations after 2011. The EC therefore says the broad consolidation measures need to be fully specified, adopted and implemented but they need to be sufficiently strengthened to address the risks from less favourable GDP growth and slippages on the expenditure or revenue side. Such a strengthening would also appear warranted in view of the high risks to long-term sustainability. Taking these risks into account, the average fiscal effort over the period of 2010–2013 may fall further short of the ¾% of GDP recommended by the Council. The high risks to long-term sustainability of public finances in Slovenia could be addressed, according to the EC, by setting a more ambitious medium-term objective, adopting and implementing the new pension indexation formula and implementing the announced further pension reform aimed at curbing the substantial increase in ageing-related expenditure.

the transition to performance-based budgeting. The programme also included wage and employment policy measures to limit the growth in remuneration of employees, and measures to curb intermediate government consumption. A key element of fiscal consolidation expected to buttress economic recovery was maximising the drawing of EU funds for the financing of investments.

In 2010, the realised general government debt and deficit were marginally lower than projected in SP2009 on the back of expenditure cuts in the Supplementary Budget. In the first year of the programming period, the achieved deficit was slightly lower than planned in SP2009 (by 0.2 p.p.) as the nominal deficit was lower. Revenue as a share of GDP was slightly above target, but the structure was different than expected. The key difference occurred in corporate income tax receipts, which were much lower due to substantially higher tax credits from the previous year, further highlighting the importance of careful revenue planning in the framing of policies for consolidation of public finances. Revenue grew at a slower-than-expected pace in the beginning of the year. With the gap between revenue and expenditure continuing to widen in the first half of the year, the Government adjusted expenditure to lower revenue with a Supplementary Budget for 2010 (see Budget aggregates of the general government sector (ESA-95) in 2010, Section 2). The biggest cuts were made to investments in transport and transport infrastructure, health and defence, with smaller adjustments made to current expenditure and transfers, where the cuts affected mainly expenditure on goods and services. In nominal as well as relative terms, the general government debt was lower than anticipated in SP2009 at the end of 2010 (see also the General government debt section).

6.2 Assessment of the consolidation of public finances in the Stability Programme

The following sections provide an assessment of the consolidation of public finances benchmarked against the assumed measures in the Stability Programmes, highlighting the changes in macroeconomic assumptions, the definition of consolidation objectives and the economic policy mix for their achievement, and realisation of the planned measures with downside risks to implementation.

6.2.1. Macroeconomic assumptions in the consolidation of public finances

Between SP2009 and SP2011, the macroeconomic assumptions underpinning the consolidation of public finances for the programming period deteriorated. In the new programme, nominal GDP projected for 2013 is lower by EUR 2.3 bn, mainly due to a less favourable domestic economic environment (relative scarcity of financing sources, worse conditions on the labour market, bigger problems with payment indiscipline), which led to a lower forecast of growth of investment and private consumption and, consequently, lower GDP growth forecast for this year and next. Nominal GDP was also dragged lower by SORS revisions in the release of national accounts for 2009, which reduced preliminary estimates by about half a billion euros. The slower-than-expected recovery has an important impact on the forecast dynamics of revenue growth, and it is affecting the fiscal policy targets (expressed as a share of GDP).

Stability Programmes 2009 and 2011 also differ significantly in the degree to which they account for planned but not yet adopted economic policy measures. SP2009 was based on a macroeconomic scenario (Autumn Forecast of Economic Trends, IMAD, 2009) that took into consideration only adopted economic policy measures. SP2011, in contrast, is based on a macroeconomic scenario that largely takes into consideration the effects of planned measures on economic growth, which particularly in the first years of consolidation leads to lower projected growth than in the scenario which includes only adopted measures (Spring Forecast of Economic Trends 2011, IMAD). In 2011 and 2012, the planned measures will cut expenditure on investments and consumption; coupled with reduced household consumption, this will reduce growth by 0.4 p.p. in each year compared to the scenario absent planned measures. In particular in 2013, additional fiscal effort to reduce the deficit below 3% of GDP will be needed in the face of further expenditure cuts and lower investment outlays. On the other hand, realisation of the planned consolidation, which would reduce the need for borrowing, would keep interest payments lower. The crowding out of expenditure would thus be less pronounced than in the event of deferral of consolidation, which would lead to higher debt levels and price of borrowing due to lenders' perception of Slovenia's creditworthiness. Better financing conditions would boost exports and private sector investments compared to the scenario with no additional measures. A forecast of economic trends for the programming period that includes only economic policy measures in force (without additional measures), however, heightens the

Table 12: **Changes in macroeconomic assumptions for the consolidation of public finances in SP2009 and SP2011**

	2009	2010	2011	2012	2013	2014
GDP in EUR bn (SP2009)	35.9	36.4	38.1	40.4	*42.6*	
GDP in EUR bn (SP2011)	35.4	36.1	36.7	38.5	*40.3*	*42.3*
Difference (in EUR bn)	-0.5	-0.3	-1.3	-1.8	*-2.3*	
Nominal GDP growth, in % (SP2009)	-3.4	1.4	4.6	6.0	*5.7*	
Nominal GDP growth, in % (SP2011)	-5.1	1.9	1.9	4.8	*4.6*	*5.0*
Difference in p.p.		0.5	-2.7	-1.2	*-1.0*	
Real GDP growth, in % (SP2009)	-7.3	0.9	2.5	3.7	*3.5*	
Real GDP growth, in % (SP2011)	-8.1	1.2	1.8	2.2	*2.3*	*2.8*
Difference in p.p.	-0.8	0.3	-0.7	-1.5	*-1.2*	

Source: SORS (in SP2009 for 2009 and in SP2011 for 2010 and 2011), Stability Programme – Update 2009, Stability Programme – Update 2011, Autumn Forecast of Economic Trends 2009, IMAD, Spring Forecast of Economic Trends 2011, IMAD.

macroeconomic risk of failure or at least an inadequate pace of consolidation, in particular towards the end of the programming period. Due to relatively slower consolidation, then, economic growth would be marginally higher in the short term, whereas the medium-term outlook would be significantly worse owing to the undermining of growth potentials.

6.2.2. Economic policy mix for the consolidation of public finances in the Stability Programme - Update 2011

In both this year's and last year's Stability Programme, the consolidation of public finances is underpinned by spending cuts, which will require a serious fiscal effort, not least due to the lower trend level of revenue compared to the pre-crisis period. According to the projections in the Stability Programme, the general government deficit will remain level in 2011 compared to last year's, as consolidation of public finances is not slated to begin until next year. The envisaged consolidation measures in SP2011 are based exclusively on measures to cut spending and restrain expenditure growth. The deficit cutting expressed in absolute sums is underpinned by the projection that revenue growth will outpace expenditure growth in relative terms. However, the trend level of revenue is lower than in the pre-crisis period, following a significant decline in 2007, when a broad-based tax reform cut corporate and household taxes with the objective of fostering competitiveness and creating an environment conducive to economic growth. But since the tax cuts were not coupled with measures to restructure and cut spending, a greater fiscal effort is now needed to balance the public finances.

This year's Stability Programme envisages a slower pace of consolidation than the previous programme. According to the projections of SP2011, the general government deficit will be over a percentage point higher in the years between 2011 and 2013 than predicted by SP2009. This year's projections thus suggest that by 2013, when Slovenia needs to correct the excessive deficit, the deficit will have dropped

Box 3: **Economic policy mix for the consolidation of public finances**

The latest analyses show that reducing the deficit by limiting and cutting expenditures yields lasting results. Recent economic literature, reviewing various approaches to the consolidation of public finances, has tended to favour cutting the deficit by curbing expenditure. Analysis shows that this approach produces more robust results than a consolidation based on raising tax rates or a combination of higher taxes and lower expenditure (IMF, 2010; EC, 1997, Alesina, Perotti, 1996, Alesina, Ardagna, 1998, McDermott, Wescott, 1996). Reigning in and cutting expenditure with economic policy measures indicates a stronger commitment by economic policy makers to the achievement of objectives, enhancing their credibility. This applies in particular when spending is held back or cut with structural changes, less so when investments and subsidies are cut or in the event of emergency measures that are typically unsustainable in the long term and cause imbalances (IMF 2011) that eventually need to be addressed (stop-and-go policies). When a policy combining measures to raise revenue and cut spending is implemented, however, raising taxes is more appropriate in the initial phase of consolidation, when measures to restructure expenditure are not yet yielding results (OECD 2007). As many as 14 EU Member States have used this approach to sorting out their public finances since the beginning of the crisis; in the early phases of consolidation they raised VAT rates, which was sustainable in macroeconomic terms considering the low inflation, and it caused fewer distortive effects since VAT is a tax with a high degree of simplicity and neutrality.

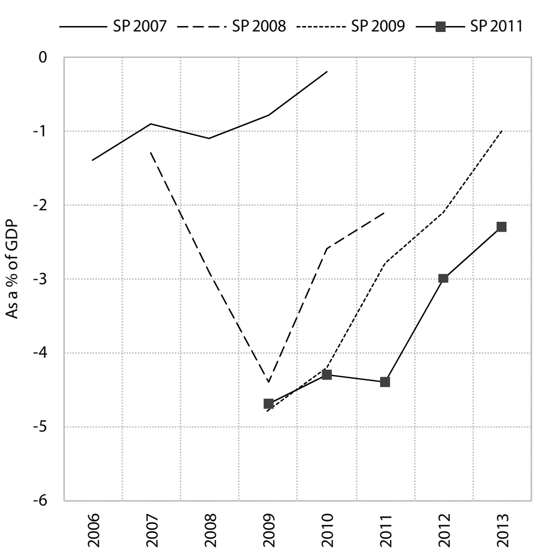
Table 13: **Comparison of revenue, expenditure and deficit in Stability Programme – Update 2011 and Stability Programme – Update 2009 (as a % of GDP)**

	Realisation		Forecast							
			SP update 2009 (January 2010)				SP update 2011 (April 2011)			
	2009	2010	2010	2011	2012	2013	2011	2012	2013	2014
Total general government revenue	43.1	43.4	43.2	42.9	*42.7*	*42.5*	44.2	43.5	*43.0*	*42.3*
Taxes on production and imports	14.1	14.0	14.3	14.2	*14.0*	*13.8*	14.2	14.0	*13.9*	*13.6*
Current taxes on income, property	8.3	8.1	8.8	8.7	*8.9*	*9.0*	8.1	8.0	*8.0*	*7.9*
Social contributions	15.2	15.2	14.9	15.0	*14.9*	*14.9*	15.1	14.9	*14.7*	*14.6*
Other revenue	5.5	6.1	4.6	4.9	*4.9*	*4.8*	6.8	6.5	*6.4*	*6.2*
Tax burden	37.6	37.4	38.0	38.0	*37.8*	*37.7*	37.4	37.0	*36.6*	*36.1*
Total general government expenditure	49.0	49.0	48.9	47.1	*45.9*	*44.2*	49.7	47.4	*45.9*	*44.3*
Intermediate consumption	6.5	6.5	6.3	6.0	*5.7*	*5.5*	6.5	6.3	*6.0*	*5.8*
Compensation of employees	12.4	12.4	12.4	11.8	*11.4*	*11.0*	12.0	11.5	*11.0*	*10.5*
Social benefits and allowances	18.7	19.1	16.7	18.9	*18.4*	*18.2*	19.4	18.5	*18.4*	*18.3*
Gross capital formation*	4.6	4.3	4.6	4.2	*4.0*	*3.8*	3.7	3.6	*3.7*	*3.2*
Subsidies, expenditure*	1.8	2.1	2.2	1.8	*1.8*	*1.3*	2.0	1.4	*1.2*	*1.1*
Expenditure on assets	1.3	1.6	1.8	1.8	*2.0*	*2.1*	1.8	2.0	*1.9*	*1.8*
Other expenditure	3.6	3.1	2.6	2.5	*2.4*	*2.2*	4.3	4.1	*3.7*	*3.6*
Net lending/borrowing	-6.0	-5.6	-5.7	-4.2	*-3.1*	*-1.6*	-5.5	-3.9	*-2.9*	*-2.0*

Source: SORS, main aggregates of the general government, April 2011, Stability Programme – Update 2009, Stability Programme – Update 2011.
Note: The forecasts of gross capital formation and expenditure on subsidies in SP2011 use baseline data that differ from the official statistical release and from the forecast in SP2009. The key difference is that the data do not include the EU's cohesion and structural policy funds for investments of legal and physical persons which are not budget users (institutional units outside the general government sector).

to just below 3% of GDP compared to a planned reduction to 1.6% of GDP in the previous Stability Programme. However, this forecast entails the risk that the ceiling prescribed by the Stability and Growth Pact will be breached in the event of even just a moderate deterioration in the macroeconomic environment. Deferring the consolidation target to subsequent years – slower consolidation than initially planned – had been witnessed in the previous years (Figure 13), which highlights the need for greater commitment and efficiency in the realisation of the planned measures.

Figure 16: **Cyclically adjusted balance – projections in the Stability Programmes, 2007–2011**

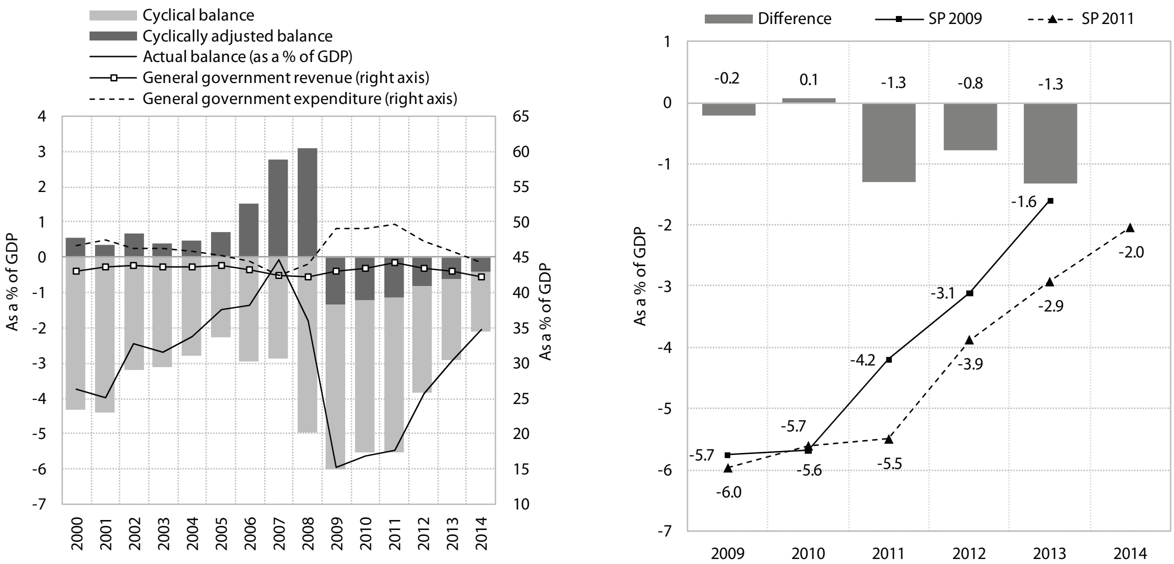


Source: Stability Programme 2007, Stability Programme 2008, Stability Programme – Update 2009, Stability Programme – Update 2011.

In this year's Stability Programme, the consolidation of public finances is again underpinned by spending cuts, but expenditure as a share of GDP has been contracting at a slower pace. Expenditure-side consolidation is based on restricting wage growth in the public sector and spending on pensions and social transfers. Measures to curb the growth in remuneration of employees that are planned for the entire duration of the programming period have the nature of emergency measures this year and next (limits on hiring, considerable cuts in performance-based pay), but they are unspecified for the period beyond 2012. To a larger degree than in the past, the projected growth in investment is contingent on co-financing from EU funds, which could lead to a significant decline in development-oriented expenditure.

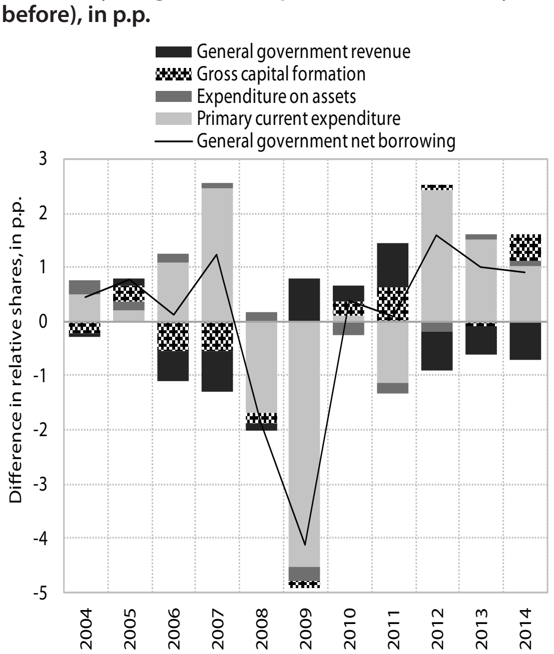
Major tax changes that would reduce the deficit are absent from this year's Stability Programme. Given the restructuring of tax sources, revenue will largely follow the trajectory of key macroeconomic

Figure 17: **General government deficit in SP2011 and comparison with SP2009**



Source: SORS, main aggregates of the general government, April 2011, Stability Programme – Update 2009, Stability Programme – Update 2011.

Figure 18: **Contribution of individual aggregates of the general government to consolidation as envisaged in Stability Programme – Update 2011 (over the year before), in p.p.**



Source: SORS, main aggregates of the general government, April 2011, Stability Programme – Update 2011.
Note: A positive change in a relative share of the deficit means a reduction of the deficit in the current year compared to the previous year. An increase in expenditure and a decrease in revenue are shown as negative values, since they contribute to a widening of the deficit.

aggregates; the only specified measures include the planned introduction of a new real estate tax system, consideration of the possibility of marginally increasing excise duties (on tobacco and tobacco products) and environmental taxes, and an update of the value added tax (simplification, crackdown on tax evasion), none of which will have a short-term financial impact.

Consolidation of public finances in SP2011 is underpinned by expenditure cuts; in principle, this produces more permanent results in deficit cutting (Box 3), but the planned measures are a departure from an economic policy mix that has been estimated to be effective, as the bulk of the measures are either unspecified or their implementation is uncertain. Efforts to reign in remuneration of employees in the public sector are inherently emergency measures, whereas no systemic changes are planned in pay and employment policies that would produce more permanent solutions while simultaneously creating a more stimulating environment for employees. Implementation of changes in social protection systems (in particular pension reform) that could also improve the sustainability of public finances remains uncertain. The proposed economic policy mix thus increases the risk that more flexible development expenditure will be crowded out in the event that the planned measures are not implemented, which would be followed by deeper cuts in expenditure on wages, pensions and social transfers. An additional risk factor is the possibility of a deterioration of the macroeconomic environment. Although consolidation is declaratively based on limiting and cutting expenditure, a key element of consolidation is the revenue trend in conjunction with the performance of the economy. In other words, despite greater emphasis on expenditure ceilings (see Fiscal framework, Section 7), the pace of consolidation is still substantially conditional on revenue dynamics.

Despite the relatively slower pace of consolidation, SP2011 does set a more ambitious medium-term fiscal target, but it is not due to be realised until after the end of the programming period. Given the slower pace of planned consolidation, the cyclically adjusted deficit in SP2011 is higher than previously planned[34] through the entire programming period, and is 1.3 p.p. above last year's plans in 2013.[35] Under this year's programme, it is thus projected to drop on average by 0.65% of GDP per year (down from the previously planned average of 0.95% of GDP per year). At the same time, SP2011 stipulates that after 2013, consolidation should continue with the aim of achieving a balanced structural budget as defined in the document Medium-term Fiscal Framework (for the preparation of the Stability Programme) that the government adopted in April this year. In that way the medium-term fiscal target was actually redefined this year and set more ambitiously (until 2010, the objective was to achieve a structural deficit of 1% of GDP). A balanced budget position in structural terms improves the stability of public finances and is more effective at curbing the growth in general government debt, but it requires a relatively stronger fiscal effort. In view of the heightened risk of a debt crisis in the euro area and the increasing emphasis being placed by rating agencies and participants in financial markets on the state of public finances in individual countries, achieving the target would have a beneficial impact on the entire economy by improving the accessibility of financing, not only for the state but also for the private sector. However, the newly defined medium-term fiscal target, a key indicator of the state of the public finances, is not set to be achieved in the programming period (until 2014) but towards the end of the term of the next government. An explanation for such a change of objective in SP2011 has not been made explicit, although it would be desired in order to improve transparency and credibility in the setting of medium-term fiscal targets and to strengthen accountability in the event that the targets are not achieved (see also Medium-term fiscal framework, Section 7.2).

[34] The cyclically adjusted deficit includes the expenditure on the NLB capital increase, unlike the structural deficit, which according to EC methodology does not include such one-off expenditure.

[35] The calculations in the Stability Programme – Update 2009 are slightly different than IMAD figures in nominal terms (see Section 2.1) owing to certain differences in the production function and the resulting differences in output gap estimates; substantively, the calculations are very similar.

6.2.2.1. General government revenue in SP2009 and SP2009

For the programming period until 2014, SP2011, much like the previous programme, does not envisage tax changes that could substantially contribute to the consolidation of public finances. The stated aim of tax policy in the programming period according to SP2011 is "maintaining a tax system that supports economic recovery and ensures stable economic growth. Tax sources will be restructured to support nominal tax revenue growth without affecting the economic growth." Both documents define tax policy in similar terms at the declarative level. Specific measures include the introduction of a new real estate tax and a possible increase in excise duties (on tobacco products and cut tobacco) and environmental taxes. In value added tax, only adherence to EU directives in the modernisation, simplification and the fight against tax fraud is planned, but in the short term these measures will not have financial impacts. In corporate income tax, the government will continue to pursue the objective of creating a competitive tax system, but no changes are forecast for this period.[36] Neither SP2009 nor SP2011 envisages any specific changes to the income tax system (e.g. in terms of the number and size of tax brackets, allowances, progressivity). It is noted that the tax changes and additional allowances adopted last year changed the distribution of the tax burden by income classes, which is why a review of all groups of taxpayers will be undertaken and changes proposed as appropriate. However, these changes are not specified in the document, nor are there any plans for changes in social security contributions. Slovenia is already among the countries with the highest social security contributions in relative terms. In 2009, social contributions accounted for 15% of GDP (EU: 13.1% of GDP), placing Slovenia behind only France, Germany, the Czech Republic and Austria in the EU. Slovenia also stands out in the structure of contributions: at 7.8% of GDP, employees' contributions are the highest in the EU (EU27: 3.9% of GDP). However, employers' social contributions as a share of total contributions are the lowest in the EU, 42.6% compared to an average of 65.8% in the EU. That considered, any additional increase in employees' social contributions would be unsustainable. For the system of social contributions, the previous Stability Programme called for a broadening of the contributions base to other remuneration, whereas in the current Stability Programme the policy of social

[36] The tax reform of 2007 cut the statutory tax rate from 25% to 20% (in 2010), while the effective tax rate is lower and even decreased last year due to higher tax breaks (to 16.4% from 17.2% in 2009).

contributions is not clearly defined. Like SP2009, SP2011 foresees improvements in tax collection, better oversight of tax collection and assessment, and the adoption of measures to crackdown on the grey economy. The latter will be achieved with the implementation of the Tax Registers Act, which will substantially cut the shortfall of VAT and other taxes collected from taxpayers with cash-based businesses. The implementation of the other proposed solutions will however either produce results over a longer time horizon or is uncertain in the first place. The planned modernisation of the tax information system will not yield results, estimated at 3% of all budget revenue, until 2014. The Prevention of Illegal Work and Employment Act, which was supposed to indirectly increase tax receipts, was meanwhile rejected in a referendum.

Under SP2011, general government expenditure as a share of GDP will be higher throughout the programming period than in SP2009, mostly because of higher revenue from other (non-tax) sources; new projections suggest a spike in non-tax revenue for this year, followed by a rapid decline. In 2010, realised general government revenue as a share of GDP was just marginally higher than projected in SP2009 (0.2 p.p.). For this year and next, however, SP2011 forecasts significantly higher revenue: 1.3 p.p. over SP2009 for this year and 0.8 and 0.5 p.p., respectively for the next two years. The dynamics of revenue growth also differs significantly, as gradual drops of its share in GDP in consecutive years had been projected earlier, whereas the new projections suggest a spike this year followed by a faster pace of decline. Given the lower forecasts of economic growth,[37] the tax burden as a share of GDP will be lower than previously projected throughout the programming period (by 0.6 p.p. this year and by 0.8 p.p. and 1.1 p.p. in 2012 and 2013 respectively). However, this year's programme projects an increase in revenue from other sources (capital, non-tax, EU), which is expected to more than offset the relative contraction in the tax burden; in all years, the share of non-tax revenue is more than 1.5 p.p. higher than in SP2009.Lower tax receipts in this year's programme also reflect a different structure of taxes compared to earlier projections, the biggest differences occurring in taxes on income and property; in SP2009, corporate and personal income tax receipts were assessed much higher and probably overestimated. The PS2011 preserves the projection of higher inflow of EU budget funds, which is projected to be 11% higher on average than assessed in SP2009; in 2012 and 2013 in particular, cohesion policy funds are projected to be higher. Given the track record, we estimate that these projections are quite optimistic, even though data for the first quarter of 2011 show that the absorption of EU funds continues to improve.

[37] Spring Forecast of Economic Trends 2011, scenario with economic policy measures (IMAD).

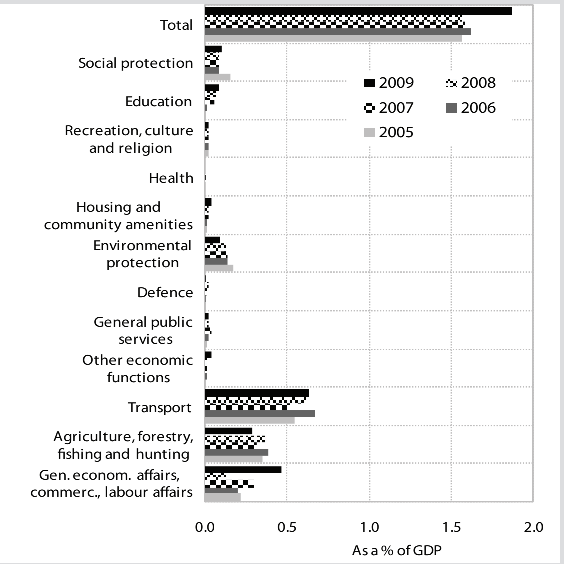
6.2.2.2. General government expenditure in SP2009 and SP2011

Both Stability Programmes assume that expenditure-side consolidation will be based on restricting wage growth in the public sector and spending on pensions and social transfers. Wage, pension and social transfer cuts have been more debated in this year's Stability Programme than in SP2009. The document assumes pensions and social transfers will be affected by changes in legislation (ZPIZ-2, Exercise of Rights to Public Funds Act), whereas the nominal wage bill is to remain at the level of 2010 throughout the programming period (see the Labour market chapter, Challenges, Section 4). Since the ZPIZ-2 was rejected in referendum and it has been proposed that the implementation of the Exercise of Rights to Public Funds Act be postponed, the effects of these cuts on consolidation this year and next will probably be more subdued than envisaged in SP2011. However, cuts in spending on wages, pensions and social transfers also reduce final consumption expenditure and household consumption expenditure, both of which decreases domestic consumption and cuts the contribution of the two categories to economic growth. A reduction of intermediate consumption is also planned, via streamlining and improved organisation of the public sector (by 0.7 p.p. of GDP by 2013 over 2010), but the measures are not precisely defined; this raises the spectre that material costs will be cut linearly, which could jeopardise the performance of basic activities, considering the different baseline positions of the budget users. Data show that there are significant differences among individual budget users in per-employee spending on goods and services, which cannot always be justified with the nature of activity or the amount of fixed costs (that are higher per employee for smaller budget users). Until a precise overview of current spending is made and the possibilities for a more rational use of funds by individual budget users assessed, it cannot be expected that actual needs and realistic scope for cuts will be taken into consideration in the cuts of this type of expenditure. Gross expenditure on capital formation will also be cut (by 0.8 p.p. of GDP), to approach the level of the year 2000 (excluding EU funds). SP2011 furthermore assumes better targeted investments and maximisation of financing from structural and cohesion policy funds, to bring

Box 4: Subsidies in the Stability Programme – Update 2011

Expenditure-side consolidation of public finances assumes a reduction of subsidies by about 0.7 p.p. of GDP by 2014 compared to 2010. This scope of reduction is theoretically feasible, as subsidies are relatively high. Before accession to the EU (in the period of ***2000–2004***) subsidies hovered at approximately 1.9% of GDP, whereupon they dropped due to a higher share of Common Agricultural Policy (CAP) funding from EU sources and remained at about 1.6% of GDP until 2008. The increase to 1.9% of GDP in 2009 was due in large part to the measures to mitigate the fallout from the economic crisis and the concurrent drop in GDP. The latest internationally comparable data[1] for 2008 show that subsidies in Slovenia substantially exceeded the EU average (1.2% of GDP), with the shares in Slovenia and the EU fairly stable in the period of ***2005–2008.*** Only four Member States had higher subsidies than Slovenia in 2009: Austria (3.8% of GDP), Denmark (2.6%), Belgium (2.2%) and the Czech Republic (2.1%). With the proposed reduction in subsidies to about 1.1% of GDP by 2014 (excluding EU funds, which are lower than in 2010), the subsidies would probably drop below the current EU average at the end of the programming period.

Figure 21: **Subsidies by function (significant functions) in Slovenia, 2005–2009, as a % of GDP**



Source of data: SORS, IMAD calculations.
Note: The data include EU funds.

It will be difficult to reduce subsidies without a radical change in structure, as the bulk of the subsidies are allocated for agriculture and transport. A half of all subsidies in 2009 were channelled to agriculture and transport, which are among the most heavily subsidised sectors in the EU. Only the Czech Republic has such an unfavourable subsidy structure. Subsidy cuts will have to include these two sectors, otherwise the potential of incentives to revive production, achieve a transition to a higher technological level and create jobs will be diminished. This policy is also supported by the policy objectives of SP2011 (page 4), which include "supporting the economic recovery and employment through improved business climate, fostering an environment for job creation in the higher value added segment of the labour market and encouraging return to the labour market." A similar development policy is also laid out by the National Reform Programme ***2011–2012***, which specifically defines programmes and projects to promote economic growth and employment: subsidies are an important instrument for the implementation of these programmes.

As part of the drive to reduce subsidies, it is necessary to thoroughly verify the effectiveness of existing subsidy programmes. Limited available sources require a targeted approach and a high degree of efficiency in meeting the objectives due to which the state is subsidising individual sectors and activities. This is a policy being pursued by both programmes.[2] There are no comprehensive assessments of the efficiency of subsidies in Slovenia. Two studies on the efficiency of state aids[3] have been made so far. They dealt with the period until 2008 and assessed the efficiency of companies which received state aid compared to other companies in the same sector that did not receive it. Both studies showed that some programmes were either inefficient or insufficiently efficient,[4] which is traced back to the fact that until 2008 state aid was received by underperforming major companies, with many of the recipients in state ownership. There have also been some studies that covered individual subsidy programmes. Considering the size of subsidies in Slovenia, we lack a comprehensive assessment of the efficiency of agricultural subsidies. Based on existing assessments of efficiency, subsidies should be: (i) more targeted; (ii) merged due to considerable fragmentation (there are too many grantors, who are insufficiently coordinated)

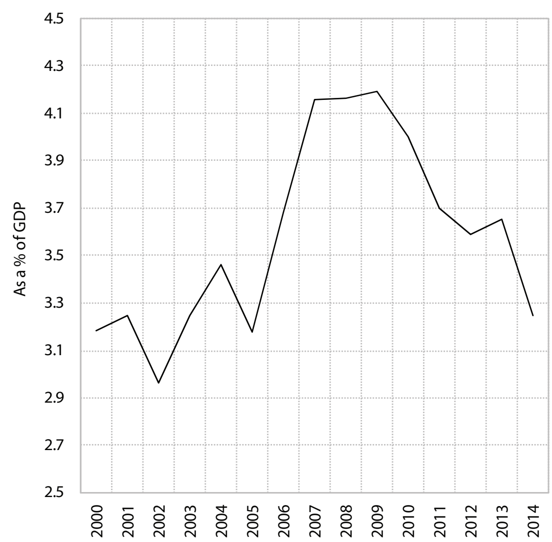
[1] Eurostat: General government by function (COFOG). The data was obtained online on 28. 04. 2011 and includes EU funds.
[2] Stability Programme – Update 2011 and National Reform Programme 2011-2012.
[3] The definitions of subsidies and state aids differ methodologically. All subsidies are not state aids, just as all state aids are not subsidies. However, a significant portion of the measures are classified as subsidies and state aids, leading to fairly inconsistent use of the two terms in practice.
[4] These studies are: Target Research Programme No. V5-0201 Competitiveness of Slovenia 2006–2013 and Target Research Programme No. V5-0408 How to Improve the Efficiency of Allocation of Public Finances: Analysis of the Effects of State Aid on Restriction of Competition. Both studies were also referred to in Economic Issues 2008 and 2010.

in order to reduce the state's administrative costs (preparation and execution of tenders), which had already been proposed by the Slovenian Exit Strategy ***2010–2013***; and (iii) regularly verify the efficiency of subsidy programmes and the success of recipients of subsidies in increasing value added and achieving other objectives that the subsidies pursue.

the total share of publicly financed investments to around 4.0% of GDP.[38]

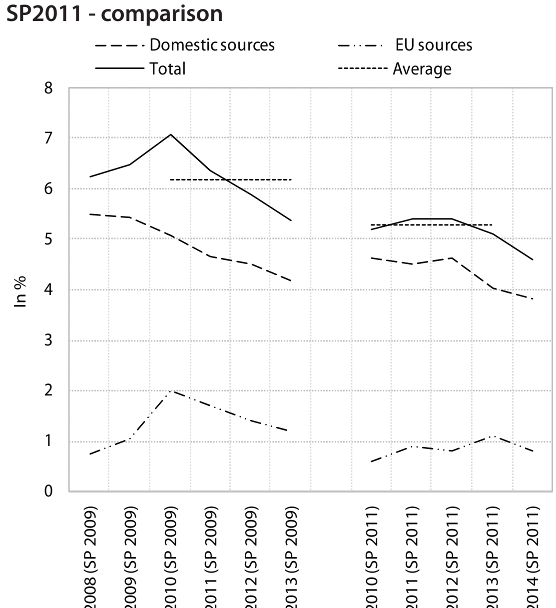
General government expenditure will drop at a slower pace than assumed by the previous Stability Programme, which is the key cause of the slower consolidation of public finances. For the next programming period, SP2011 projects a gradual drop in expenditure that is, however, not as ambitious as in SP2009 (SP2009 projected a drop of 4.7 p.p. of GDP in 2011–2013, while SP2011 assumes a cut of only 3.9 p.p.). The dynamics of consolidation are also different: under SP2009, expenditure was to be cut significantly in 2011, but in SP2011 expenditure is actually projected to be higher this year; after 2011, the dynamics of expenditure cuts is similar than in SP2011. Additional fiscal effort is not predicted, even though expenditure is being cut from a higher level. This year's spending hike is partially a consequence of the inclusion of funding for the recapitalisation of the biggest state-owned bank, NLB, in the amount of EUR 243.4 m, equalling 0.7% of GDP, and partially due to higher social benefits and supports, and other expenditure.[39] The expenditure increase due to the bank recapitalisation is in methodological terms a one-off event than will not permanently increase general government expenditure (although it will increase interest expenditure), but it was not planned in the previous Stability Programme and will therefore slow down consolidation this year. To enhance the commitment to the consolidation targets outlined last year, it would be sensible to secure at least a part of these funds with savings on other expenditure. In terms of public finances, it would have been wisest if the state capital increase at NLB had been carried out in 2009, when the European Commission allowed Member States to grant state aid to the financial sector as part of measures to tackle the financial crisis. Such schemes were approved for a six-month period with the possibility of extension, and the Commission approved 16 schemes until 30 June 2010 at the latest. In November 2008 Slovenia notified the Commission of the Guarantee Scheme for credit Institutions in Slovenia and in the notification process mentioned possible recapitalisation measures. The European Commission approved state aid under the guarantee scheme in the amount of EUR 12 bn (gross), but the

Figure 19: **Investment expenditure in SP2011**



Source: SORS, Stability Programme - Update 2011

Figure 20: **Investment expenditure in SP2009 and SP2011 - comparison**

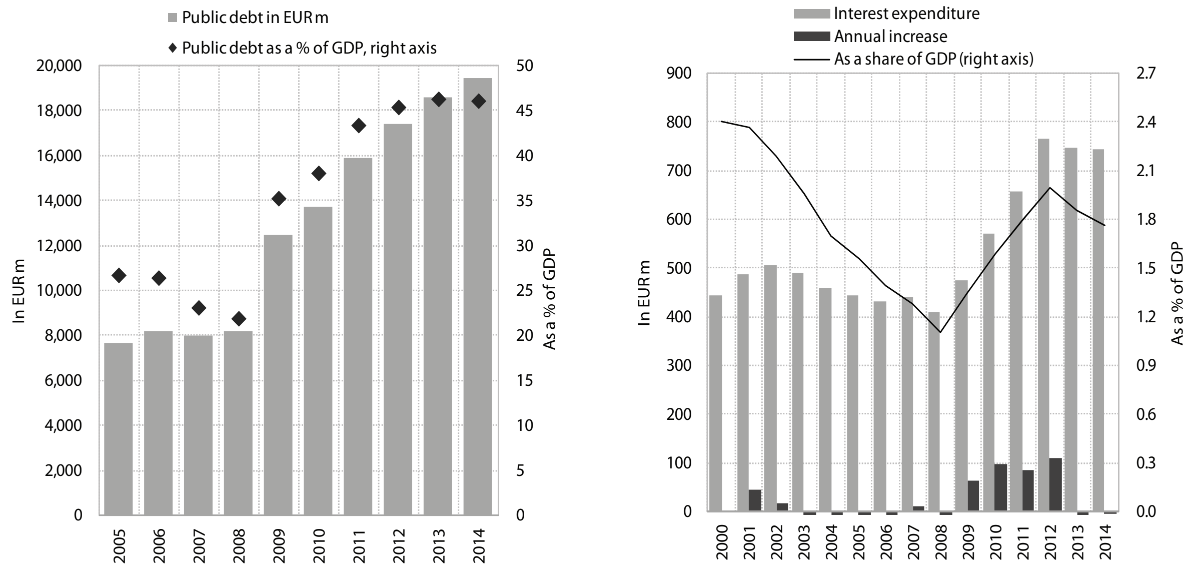


Source: SORS, Stability Programme - Update 2009, Stability Programme - Update 2011

[38] The key difference relative to the gross capital formation is the planned drawing of structural and cohesion policy funds by beneficiaries outside the institutional general government sector, which is increasing in the programming period.

[39] Due to methodological changes, the line item "Other expenditure" is not comparable to last year's Stability Programme.

Figure 22: **General government debt and interest expenditure in SP2011**



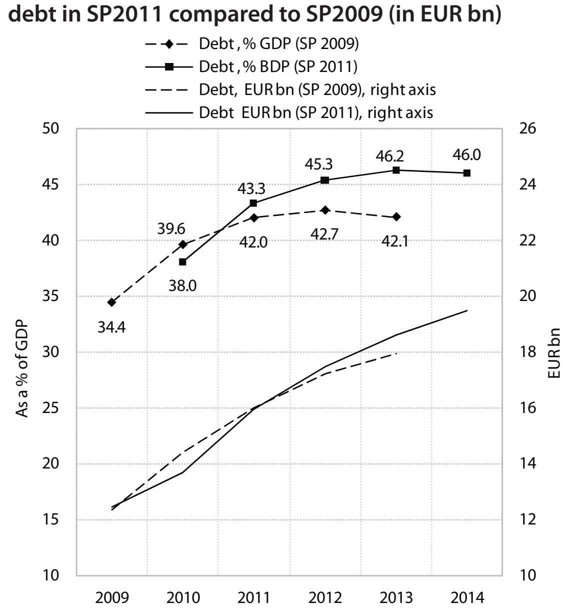
Source: SORS, Stability Programme – Update 2011.

potentially permitted aid worth EUR 10 bn remained unused.[40] Had the recapitalisation been carried out in 2009, the transaction would not have counted towards general government expenditure; nevertheless, it would have increased the general government debt.

6.2.2.3. General government debt in SP2009 and SP2011

Under this year's Stability Programme, general government debt will be higher than planned last year. In SP2011, general government debt as a share of GDP is higher than projected in SP2009 throughout the entire programming period, largely due to slower-than-projected nominal GDP growth and partially due to different dynamics of deficit reduction; as a result, debt stops growing a year later than under SP2009. It is somewhat surprising, however, that interest expenditure in 2013 is lower than planned last year even though the debt is higher in nominal terms.

Figure 23: **Change in nominal general government debt in SP2011 compared to SP2009 (in EUR bn)**



Source: Stability Programme – Update 2009, Stability Programme – Update 2011.

Table 14: **Comparison of general government debt in Stability Programme – Update 2011 and Stability Programme – Update 2009 (as a % of GDP)**

	Realisation		Forecast							
			SP update 2009 (January 2010)				SP update 2011 (April 2011)			
	2009	2010	2010	2011	2012	2013	2011	2012	2013	2014
General government debt	35.2	38.0	39.6	42.0	*42.7*	*42.1*	43.3	45.3	*46.2*	*46.0*
Interest expenditure	1.3	1.6	1.8	1.8	*2.0*	*2.1*	1.8	2.0	*1.9*	*1.8*

Source: SORS, main aggregates of the general government, April 2011, Stability Programme – Update 2009, Stability Programme – Update 2011.

[40] In 2009, state guarantees were awarded to the banks NLB (EUR 1.5 bn) and Abanka Vipa (EUR 0.5 bn).

Rapid debt growth heightens the risk that it may exceed 60% of GDP in the event of macroeconomic shocks. Under SP2011 projections, general government debt will total EUR 11.3 bn at the end of the programming period, 24.1 p.p. of GDP higher than at the end of 2008. The brisk pace of debt growth is exacerbating the risk that debt will exceed 60% of GDP in case of a renewed economic crisis. Another key risk factor is state guarantees, which already exceed 20% of GDP.

7. Fiscal framework

The Slovenian fiscal framework has been substantially redefined in the last two years. The main changes relate to budget preparation (the macroeconomic forecasts used and to what extent fiscal policy measures and budget planning are considered), changes to the medium-term fiscal framework (the way expenditure ceilings are set), redefinition of fiscal targets, and monitoring fiscal policy developments with a view of stability and sustainability (establishment of a fiscal council). Other important changes in budget planning and the medium-term fiscal framework are related to modifications to the coordination of fiscal policies at EU level and the introduction of the European Semester which provides the EU Council (supported by the European Commission) with the possibility of influencing *ex ante* budget developments in Member States (see also Fiscal Development and Policy in the EU, Section 1). These changes to the broader fiscal framework in Slovenia are reviewed in light of their contribution to the efficiency, transparency and accountability of fiscal policy in delivering fiscal stability and enhancing ownership.

7.1. Budget preparation and adoption

Important changes concerning budget preparation and adoption include those introduced to the macroeconomic forecasting process and changes to budget planning. Regarding macroeconomic forecasting, two important changes have been made that have important implications in terms of transparency and credibility of fiscal projections. The first change concerns the option of using different underlying forecasts in budget preparation and the second is related to the inclusion of planned but not-yet-adopted fiscal policy changes. Following the introduction of a programme-based budget (in 2009), changes were introduced to budget planning last year in order to address certain problems in existing process of budget preparation.

7.1.1. Macroeconomic forecasts used in budget planning

With the adoption of amendments to the Decree on Development Planning Documents and Procedures for the Preparation of the National Budget in 2010, the government can now use not just one but alternative macroeconomic forecasts, which reduces transparency. Before the amendments to the

Decree on Development Planning Documents and Procedures for the Preparation of the National Budget (hereinafter: Decree on Development Planning) in 2010, the budget was prepared based solely on the forecast by the Institute of Macroeconomic Analysis and Development (IMAD). These forecasts had been regarded as being realistic and independent by international institutions (OECD 2011 and European Commission 2010), their impartiality and success confirmed by annual assessments of the precision of forecasting.[41] The European Commission has designated IMAD as an example of best practice in the preparation of independent forecasts and their use in budget preparation. Now, with the Decree on Development Planning being amended in 2010, the government can use alternative forecasts (European Commission, Bank of Slovenia, IMAD and OECD) in planning the budget. These forecasts are released at different times and are therefore different. The Decree on Development Planning does not determine how to consider the different forecasts and deliver consistency and continuity of the used assumptions in budget planning, which undermines transparency and heightens the risk of arbitrary adjustment of the assumptions. This is why the OECD in this year's Economic Survey of Slovenia (OECD 2011) recommended a return to the previous practice of solely using IMAD's forecast and strengthening its independence towards the role played by the Central Planning Bureau (Centraal Planbureau - CPB) in the Netherlands.

In the preparation of Stability Programme – Update 2011, a change was introduced with the inclusion of the effects of planned but not yet made economic policy measures in the macroeconomic assumptions that form the basis for fiscal projections in the programming period. Until 2010, when preparing the budget and fiscal projections for reporting to the EU, the underlying macroeconomic scenario did not include planned fiscal policy changes but only adopted policies and fiscal and economic policy measures. Starting in 2011, however, the forecasts of fiscal aggregates are made using a macroeconomic forecast that includes planned fiscal policy measures, including measures that are still being deliberated and have not yet been adopted (see Section 6.2.1). Even though the Decree on Development Planning does not precisely define which macroeconomic forecast scenario is used for budget preparation, the change in the preparation of this year's Stability Programme suggests that the forecast which includes planned economic policy measures will also form the basis for other budget planning documents. In view of the recent recession, this change is justified to a certain degree: using a forecast without consideration for fiscal consolidation measures and its effects on the economy would make for an inconsistent basis for fiscal planning and would worsen the fiscal position in the medium term. In order to improve the credibility of fiscal projections, then, it is necessary to more clearly define the basis for the preparation of the target projection of macroeconomic aggregates, as the projection ought to take into account only the specific changes that the Government has already debated and decided to adopt. Otherwise, the projections could also be affected by changes on which consensus has not been reached and will not be realised in practice, which would mean that the assumptions in the target scenario were wrong. With regard to the effects of not-yet-agreed measures, it would be appropriate to make only partial calculations showing the consequences if they were actually adopted.

7.1.2. Budget planning

With changes to the way the national budget and municipal budgets are being prepared, the government has addressed two problems in the previous budget planning process related to the framework of expenditure and its link to development priorities (see also Economic Issues 2010)**.** The first weakness was disregard for the global expenditure framework, the second a failure to take into account development priorities. Under the new system, the global expenditure framework is determined with a fiscal rule, and expenditure by policy is carried out based on priorities set before the start of coordination with the financial plans of budgetary users, making it more likely that the budget will actually be framed so as to take into account the global expenditure framework and the development priorities laid out in the budget memorandum. However, inconsistencies may occur in the setting of development priorities in development planning documents and the budget memorandum, a result of a lack of connection between development and budget planning that is reflected in different and isolated priorities. Heretofore, it has often happened that adopted development planning priorities differed from the priorities set in the budget memorandum, in particular at times of change in government, when governments honoured the adopted coalition agreements but failed to appropriately adjust development planning documents. This problem can be solved with on-going verification of development priorities and with changes and harmonisation of the documents which define them. An even bigger problem is adherence to the set development priorities in the adoption of

[41] See Spring Forecasts of Economic Trends (http://www.umar.gov.si/en/forecast/spring_forecast/).

Box 5: ***Change in budget planning in Slovenia in 2010***

The budget planning procedure[1] was altered last year. The Decree on the Documents of Development Planning Bases and Procedures for the Preparation of the Central and Local Government Budgets amended in 2010 determines the course of the procedure over multiple phases. It begins with the preparation of the budget memorandum, which *inter alia*: (i) determines an expenditure ceiling for the current year and three years thereafter with a fiscal rule; (ii) defines priorities by policy[2] and the requisite structural changes; and (iii) determines the global breakdown (estimate) of expenditure by programme classification to the level of policies, programmes and sub-programmes for the current years and three years thereafter. At its first budget session (by 25 May), the Government determines: (i) the expenditure ceiling stating the target debt and deficit/surplus for the next four years; (ii) national development priorities for the accounting period; and (iii) breakdown of expenditure to the level of policies for the next two years and an indicative breakdown for the two years thereafter. After the first budget session, working groups covering individual policies begin a final round of coordination. The working groups propose a coordinated breakdown of expenditure for the current and next year by programmes and sub-programmes. At its second budget session (by the end of June), the government determines for four years: a breakdown of expenditure for policies, programmes and sub-programmes, and a breakdown by proponents of the financial plans. Based on the second budget session, the minister responsible for finance issues an instruction for the preparation of financial plans by budget users. The proponents put a proposed financial plan to the Ministry of Finance by 15 August. The proponents of financial plans must coordinate the planning with the Health Insurance Institute of Slovenia, the Pension and Disability Insurance Institute of the Republic of Slovenia, public funds, public institutes and agencies founded by the state, as well as other entities that receive budgetary funds. The minister in charge of finance puts the budget memorandum and the draft budget to the Government by 20 September. By 1 October, the government submits the budget memorandum and the draft budget to the National Assembly, which adopts it.

[1] Since 1999, the procedure is in principle laid down in the Public Finances Act and detailed in the Decree on the documents of development planning bases and procedures for the preparation of the central and local government budgets (Official Gazette RS, No. 54/2010). The procedure applies by analogy to the preparation of municipal budgets.
[2] In the performance-based budget, expenditure is allocated to thirteen policies: (i) promotion of entrepreneurship and competitiveness; (ii) higher education, science, technology and information society; (iii) labour market; (iv) education, culture and sport; (v) transport and transport infrastructure; (vi) energy; (vii) agriculture, forestry, fisheries and food; (viii) environmental and spatial policy; (ix) social security and health care; (x) institutions of the political system; (xi) national security, defence and foreign affairs; (xii) governance of public administration systems; (xiii) enhancement of institutions enforcing the rule of law, freedom and security; and the special expenditure groups and three line items for other expenditure (debt servicing, payments to the EU budget and reserves). Of the thirteen policies, nine, covering economic, social and environmental development, are singled out as having a significant impact on development. The policies are divided to programmes and sub-programmes.

supplementary budgets. Even when development priorities laid down in the budget memorandum were taken into account in budget adoption, subsequent changes (supplementary budgets) often ignored them. Supplementary budgets were frequently enacted linearly, affecting all budget users, who in turn primarily cut development expenditure, i.e. the easiest way to achieve spending cuts. Actual budget realisation also tends to be off-target on development priorities. Typically, budgets are not realised on investments and other development projects due to delays in the preparation of projects; public contracting procedures are also long, in particular when there are complaints.

A development-oriented budget framed around policies, programmes and sub-programmes provides a basis for evaluating the efficiency of expenditure, albeit not in an internationally comparable way. The formation of policies and comprehensive expenditure programmes, sub-programmes and measures by policy, which has replaced fragmented budget line items, delivers a framework for assessing the efficiency of expenditure. A system of indicators has also been set up to measure the meeting of targets and the effects of programmes, projects and individual measures. Such a system may make it possible to discontinue expenditure on inefficient programmes and to make *ex ante* evaluations of the potential efficiency of new programmes and measures. The collection of assessments of individual programmes, projects and measures in the framework of each policy, and an assessment of development of the areas covered by the respective policies, also make it possible to evaluate the efficiency of policies. However, the system does not comply with international classifications; in this case, the Classification of the Functions of Government (COFOG, United Nations), while reporting of general government expenditure, does not adhere to the standards of the International Monetary Fund (Government Finance Statistics Manual, 2001). Some of the data and the resulting indicators will therefore not be internationally comparable.

7.2. Medium-term fiscal framework

Reforms of the fiscal framework in Slovenia have been proceeding in the direction of making explicit the objective of fiscal stability in the government's policy agenda, and for governments to deliver on it. However, the new EU fiscal framework, which introduced the so-called European Semester, provides the Council of the EU with the possibility of *ex ante* influencing national fiscal policies. This is appropriate in terms of enhanced coordination of economic policies in the EU context (see Fiscal Development and Policy in the EU, Section 1), but the change also requires that a national fiscal policy is firmly anchored in a domestic framework in which the role of government (formation of fiscal objectives and fiscal and economic policy measures implementing them) and the mechanism for oversight of the set fiscal strategy are clearly defined.

In April 2011, the government adopted a medium-term fiscal framework (MFF) as a basis for the preparation of the Stability Programme – Update 2011, expanding the definition of fiscal objective and making explicit the link between the targets and the expenditure ceiling, which is defined as a fiscal rule. Before the introduction of the new framework for setting expenditure ceilings, the budget procedure was set in a medium-term budget framework that determined two-year expenditure ceilings for the state budget. The ceilings, which had not been fixed and were changing depending on circumstances, were determined on a cash basis (cash flow) and actually constituted fiscal objectives, even though since 2005 Slovenia has pursued the medium-term objective of achieving a structural deficit of 1% of GDP (based on accrual accounting, not cash basis). The new MFF envisages that: (i) the actual deficit will drop to below 3% of GDP by the end of 2013; (ii) a balanced structural budget position will be achieved within the duration of one economic cycle; (iii) the debt may not exceed a ceiling of 45% of GDP for the duration of consolidation (until 2016). The debt and structural balance targets are ceilings that still allow for the achievement and preservation of a sustainable fiscal position in the long term, provided that pension reform is implemented. In addition to expanding the definition of fiscal target, which now includes the budget balance as well as relative debt, another key novelty is the inclusion of ageing-related expenditure in the medium-term fiscal target (see Section 5).

The new framework for expenditure ceilings has brought changes in included fiscal aggregates, the time frame and the link between ceilings and fiscal targets. The MFF introduced the following changes in setting expenditure ceilings: i) it redefined the fiscal aggregate to which the ceilings apply; ii) it changed the time dimension to which the ceilings apply and; iii) it made explicit the link between the targets the government pursues and the expenditure ceilings.

The expenditure ceiling "fiscal rule" applies to total general government expenditure, which requires oversight of spending of all four balances constituting the general government sector. In 2009, a ceiling on state budget expenditure (excluding EU funds; see also Exit Strategy 2010–2013) was set for the preparation of 2010 and 2011 budgets. The formal implementation of the medium-term fiscal framework with the 2010 amendments to the Decree on Development Planning expanded the definition of fiscal aggregates to which the ceilings apply. The ceilings apply not only to budget expenditure but to all general government expenditure, including expenditure financed with EU sources.[42] Setting ceilings at the level of overall expenditure is appropriate in view of the achievement of the planned fiscal targets, but additional changes and adjustments would be welcome: the government prepares and the parliament adopts the national budget and confirms the financial plans of the health and pension budgets, determining the expenditure level of these three budgets, but this does not apply for the budgets of the level of local governments. The ceiling thus extends to expenditure on which the government, although its sets the ceiling, does not have direct influence. In the event that local government budgets' expenditure is included, this problem would be compounded. In order to effectively implement the ceiling (i.e. ensure that overall expenditure of the general government moves in accordance with a desired policy path), it is necessary to adjust the method for determining state budget transfers to local government as a means of influencing their expenditure developments. Moreover, the existing debt rule applied to local government could also be revised in view of the rapid growth in local government debt in recent years (see General Government Debt, Section 4).[43] The other contentious issue with regard to the coverage of the

[42] The ceilings apply to the general government sector based on the definition in the national methodology, and they are measured by paid invoices.

[43] The draft Public Finances Act steps up oversight of municipal-budget planning and extends it to indirect budget users. Municipalities are to be bound by the new rules on the management of property and borrowing. Oversight of budget spending is to be facilitated with the introduction of a summary balance in municipalities' closing accounts, which will provide a more comprehensive insight into the state of public finances at municipal level.

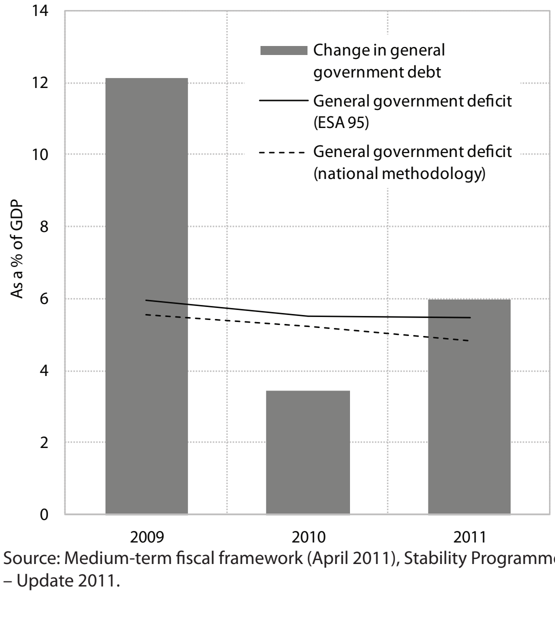
rule is that it also applies to expenditure financed with EU sources, which should be maximised, not limited. In including interest payments under the fiscal rule, it is important that such expenditure be planned realistically. Any systematic underestimation of interest payments would show up in lower expenditure projections. Indeed, higher-than-planned realisation of interest expenditure would – in order to ensure compliance with the "fiscal rule" – eventually crowd out other expenditure. Exempting this expenditure from the "fiscal rule" does not make sense as it would render it impossible to internalize the crowding-out effect in expenditure projections.

The introduction of the "fiscal rule" allows for the setting of a global expenditure framework and limits potential spending increases in the course of the budgetary debate in government and parliament procedure, but there are some limitations to the way it is calculated. The expenditure ceiling is set based on two components: an estimate of potential output and a combination of discretionary elements. The first component may change due to external influences (outside the scope of fiscal policy). The estimate of potential output is changeable, depending on the methodology used, revisions of past data and the forecasts considered (see Section 2.1). The second component represents parameters that determine the expenditure dynamics in accordance with the government's primary expenditure and debt targets. Even though – unlike in the first component – the link between the expenditure ceiling and fiscal policy target is explicit, the selection of parameters is discretionary, undermining the efficiency of the fiscal rule by creating room for adjustment and arbitrariness in the selection of the ceiling.

It would seem appropriate to amend the set fiscal targets and provisions in order to enhance the commitment to the fulfilment of fiscal policy targets. Fiscal targets – consolidation trajectories – are defined in the MFF with two related variables: target debt and primary balance. Considering that they are related, it would seem appropriate to choose just one variable or rank them by order of importance based on economic logic, liabilities and long-term risks. One option could be to give preference to the debt-to-GDP ratio which, in the context of euro area, where there is no independent monetary policy, anchors the creditworthiness of the government and overall cost of financing for the whole economy. In addition, the debt-to-GDP ratio provides an indication of the country's capacity to absorb macroeconomic shocks. The way fiscal policy should be framed is to stabilise relative debt and then achieve a trend reduction, which improves the country's ability to respond to shocks. A fiscal policy that pursues the objective of reducing the debt-to-GDP ratio should moreover provide a sufficient safety margin for not breaching the deficit ceiling (3% of GDP), and take into account the contingent liabilities arising from ageing. To enhance commitment to the implementation of fiscal policy objectives, a provision on the balancing of expenditure and revenue should be formally adopted. Specifically, this would mean that in the event of implementation of systemic measures that would result in lower revenue (e.g. tax cuts), the shortfall of revenue would have to be fully covered with other sources or with spending cuts.

The amended MFF does not make perfectly transparent the link between the medium-term target that Slovenia needs to meet in the context of the EU's fiscal framework and present in the Stability Programme, and the levels of target variables being pursued in the MFF. Projections of the budget balance in the MFF are made with the national methodology, which is based on the International Monetary Fund methodology GFS 1986 (cash flow), whereas in the Stability Programme they are based on ESA 95 methodology. As illustrated in Figure 19, there is a larger difference between the envisaged change in the general government balance for 2011 measured based on national methodology and debt (1.2% of GDP) than between debt and deficit measured based on ESA 95 methodology (0.5%). The difference stems from a different definition of the scope of the general government between national methodology and ESA methodology; a transition to GFS 2011 would solve this problem (see Economic Issues 2010, Box 6).

Figure 24: **Comparison of general government balance in MFF and SP2011 with change of debt**

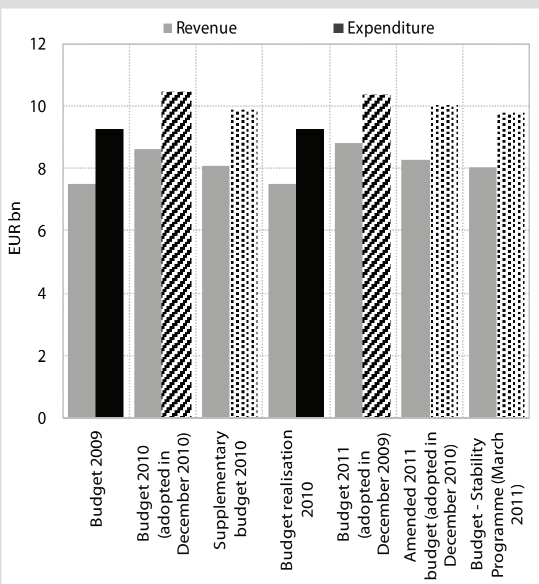


Source: Medium-term fiscal framework (April 2011), Stability Programme – Update 2011.

Box 6: ***Expenditure ceiling – the track record***

While the new framework for setting expenditure ceilings was formalized in 2010 and applied to the 2011 and 2012 general government budgets, it is still possible to assess its effective contribution in anchoring budget developments by looking at its early implementation as applied to expenditure ceilings set in 2009 for the 2010 and 2011 state budgets. Figure 21 shows that the expenditure ceiling for the 2010 adopted state budget and derived from the new framework (EUR 10.4 bn) was first adjusted downwards in the supplementary budget adopted in July 2010 (EUR 9.8 bn) and that the 2010 budget outturn was even lower expenditure (EUR 9.2 bn).[1] The adopted 2011 budget is undergoing similar dynamics: the original ceiling was already adjusted downwards in line with revenue developments in order to meet fiscal targets.

Figure 25: **Planned and realised budget revenue and expenditure**



Source: Ministry of Finance (Closing account of the RS budget for 2009, State budget 2010, Supplementary state budget 2010, Realisation of state budget 2010, State budget 2011, Supplementary state budget 2011), Medium-term fiscal framework and Stability Programme – Update 2011.

[1] In the 2010 budget, the expenditure ceiling applies only to expenditure financed from own sources. Nevertheless, the downward correction had approximately the same scope as for total expenditure.

In terms of transparency and credibility in the setting of fiscal targets, and accountability for their potential non-implementation, the government should clearly present long-term as well as medium-term targets for the period of its term in office. In Stability Programme 2011, the medium-term target was defined and set in terms of a balanced budget position in structural terms. While the target was set at a more ambitious level than previously (a structural deficit of 1% of GDP; see also Section 6.2.2), it is not aimed to be met in the programming period (until 2014) but towards the end of the term of the next government. In terms of transparency and credibility in the setting of fiscal targets, and accountability for their potential non-implementation, the government should clearly present long-term as well as medium-term targets and the fiscal rule for the period of its term in office. One possibility would be to set a legally binding framework (e.g. in the Public Finances Act) requiring that the newly elected government must form a fiscal strategy with targets that it will set out to meet during its term in office, in accordance with its more broadly defined priorities and policies. Such a fiscal strategy would be presented to the National Assembly, which would approve it and monitor its implementation annually with the support of existing independent fiscal institutions (see section Monitoring compliance of fiscal policy with fiscal stability targets). In that way, the time frame would be similar to the system in place prior to the amendments to the Decree on Development Planning, but with the added commitment for the government to explain any deviation from the targets set in the fiscal strategy.

In 2010, the Government founded the Fiscal Council as a consultative body for the independent evaluation of fiscal policy and the implementation of structural reforms. Modelled on examples of best practice from several EU Member States, which is also recommended by the OECD, the Government established an institution whose task is to independently monitor the implementation of fiscal policy and its compliance with the set targets. The tasks of the Fiscal Council are currently defined very broadly,[44] while the draft Public Finances Act

[44] The tasks of the Fiscal Council as defined in the current Public Finance Act (Official Gazette RS, No. 11/2011):
1. To prepare an ex post assessment of the sustainability and stability of fiscal policy as determined in the annual budget memorandum and the Stability Programme, and in conformity with the provisions of the Stability and Growth Pact. The assessment of conformity accounts for the economic cycle and may be based on an independent assessment of economic trends by the Fiscal Council. 2. To evaluate the suitability of budgetary objectives relative to the medium-term fiscal framework. 3. To provide an annual evaluation based on the closing account of the effectiveness of the use of budgetary funds, including EU funds. 4. To evaluate the trend changes in individual revenue and expenditure categories in terms of their impact on the sustainability of public finances, using data from the closing account and the adopted budgets for subsequent years. 5. To evaluate whether the government's fiscal policy is on target for long-term sustainability of public finances in view of the ageing

envisages that they will be redefined to refocus it on evaluation of implementation of fiscal policies. To enhance the formal independence and impartiality of the Fiscal Council, it would be appropriate to change the appointment procedure: members of the Fiscal Council should no longer be appointed by the government but by expert institutions; they should be confirmed by the National Assembly, which would also adopt the Fiscal Council's annual reports. This would also enhance the role of the National Assembly in oversight of implementation of fiscal policy.

of the population. 6. To assess the transparency of public finances and the quality of economic forecasts used in budget planning. 7. To assess the effectiveness of implementation of structural policies in the light of ensuring the long-term sustainability of public finances, economic growth and employment. 8. To assess the government's borrowing and guarantee policies in view of the sustainability and stability of public finances.

8. Fiscal policy challenges in the process of consolidation of public finances

Consolidation of public finances and abeyance of the excessive deficit procedure in 2013, which has significant implications for Slovenia's perception by financial markets and the availability of financing for the entire economy, will require substantial fiscal effort and is subject to numerous risks. The planned spending cuts, designed to reduce general government expenditure by 4.9 p.p. of GDP, are largely undefined in the explanations of SP2011. A substantial part of the measures have not yet been adopted, whereas in some areas – remuneration of employees as well as social benefits – they are savings-oriented (emergency) measures which do not have sufficient long-term impacts to provide for a more sustainable reduction in the level of expenditure. The planned reduction in remuneration of employees for the entire general government sector is more substantial than in the previous Stability Programme. In 2011, these funds are set to drop by 0.6% in nominal terms (as opposed to 0.1% growth in SP2009). This is expected to be achieved not only by limiting wage growth in state bodies, as was the case in SP2009, but also by limiting hiring in the institutional government sector (an emergency law due to take effect this year is in the works). Pursuant to the MFF, remuneration of employees would remain roughly at the achieved level until 2016. According to our estimate, freezing hiring in the public sector would substantially affect the quality of public services, especially in health and social care, where there is already a need for additional employment due to demographic trends. Also very likely is a continued reduction in expenditure on investments and subsidies, which can be achieved more easily than cutting spending with systemic changes. Considering that the pension reform will not be implemented after it was rejected in a referendum, additional measures will have to be adopted in the coming years as pension expenditure starts to grow. All this will have an adverse impact on competitiveness and economic growth, and, combined with the emergency measure of restricting hiring, on the accessibility of a number of public sector services. Restricting expenditure, which plays a key role in boosting development (investments, subsidies), and postponing the necessary tax changes designed to raise competitiveness, would further reduce the economy's potential for faster growth and improvement in living standards.

The track record shows that the dynamics of fiscal consolidation are still driven by expenditure dynamics; it is therefore vital that an economic policy mix aimed at sustainable expenditure reduction be framed and consistently implemented. Even though this year's Stability Programme posits a similar economic policy mix – indeed, in some segments the measures are even more restrictive than planned last year – the projected deficit at the end of the programming period is nevertheless higher. The slower pace of consolidation in SP2011 is in significant part the result of altered economic circumstances and macroeconomic assumptions, which also led to the proposal for a supplementary budget for 2011 (June 2011). Although consolidation is declaratively based on limiting and cutting expenditure, this shows that the key element of consolidation is the expenditure trajectory as determined by the economic environment. To put it differently, despite a greater emphasis on expenditure ceilings in SP2011 (see Fiscal framework, Section 7), the dynamics of consolidation are still largely driven by expenditure dynamics. This calls for measures (economic policy mix) which will put the consolidation of public finances on a more sustainable footing. A substantial portion of these measures are envisaged in documents adopted by the Government (Exit Strategy 2010–2013, SP2009, SP2011, Competitiveness of the Slovenian Economy – Overview and Measures for Improvement, Commitments for the Pact for the Euro), but they are either not yet being implemented or have been implemented too slowly and in a piecemeal fashion.

A part of the spending cuts can be achieved with savings measures and streamlining, not with linear cuts but with the creation of a system that will allow for greater flexibility in wages and hiring, consistent implementation of measures to improve the efficiency of the public sector, and streamlining of operations. In particular, in employment and wage policies it is necessary to create a system that will improve the flexibility of remuneration and facilitate making redundancies (firing). This would make it easier to consider actual needs and take action to maximise efficiency. In material costs, too, savings can be achieved with a thorough review of current spending and an assessment of the potential for rationalising spending by individual budget users. This could avert across-the-board cuts that could jeopardise the performance of budget users' principal activities, considering their different baselines. Data show that there are significant differences among individual budget users in per-employee spending on goods and services, which cannot always be justified with the nature of activity or the amount of fixed costs that are higher (per employee) in smaller budget users. Considerable savings can also be made by improving the efficiency of public contracts, which account for approximately 10% of GDP. However, measures in these areas alone do not provide sufficient scope for a more permanent consolidation of public finances.

A broader and consistent solution to reducing total expenditure as a share of GDP lies in restructuring expenditure with measures to improve efficiency and with structural reforms geared towards strengthening the role of development expenditure promoting competitiveness and maintaining the long-term sustainability of social protection systems. Restructuring expenditure and improving the efficiency of development expenditure would accelerate consolidation and have a positive impact on competitiveness. Consistent preparation of the budget along programming priorities and exclusion of inefficient programmes would go a long way towards achieving that. There are reserves in expenditure on agriculture (which account for an above-average share of the budget), railways and state aids to troubled companies and old industries. Competitiveness would also receive a boost with improved efficiency of spending on R&D and education,[45] adjustments in the management of public institutions and the public administration, and measures enhancing the promotion of small business. In the financing of public investments vital to economic activity, it is necessary to actually carry out the transition to priority financing with EU funds as stipulated by SP2011, and consider enhancing public-private partnerships. In particular in the provision of individual public goods (education, health care, social protection, culture, sport), a part of the burden should be shifted from the state onto the private sector, which should be coupled with accelerated development of long-term care services that are insufficient, considering the current and future needs of the population. It is however necessary to bear in mind that the key factor determining the state of public finances over the medium and long term is the changing demographic structure of the population. A more permanent consolidation of public finances and hence lower demand for borrowing can be achieved only with contemporaneous structural adjustments in social protection. Pension reform is essential to flattening the trajectory of pension expenditure and raising the retirement age. Additionally, pressure on expenditure growth will be alleviated by reform of health care and long-term care. The majority of these measures are envisaged in the abovementioned government documents, it is crucial that they be adopted as soon as possible and implemented in a comprehensive fashion.

[45] See also Development Report 2011, IMAD.

On the revenue side, the scope for increasing the tax burden is limited;[46] ***it seems appropriate, however, to raise certain indirect taxes and to broaden the tax base.*** Higher taxes on labour and capital would have an adverse impact on economic activity and competitiveness, which, particularly in a period of slow and uncertain recovery, would have a dampening effect on the economy. Tax policy in these fields needs to focus on improving the tax capacity by preserving the current tax rates and broadening the tax base in order to eliminate the current distortions (student work). Also important is the implementation of measures to simplify tax procedures in order to promote registration of activities and reduce the scope of the grey economy, and to improve the information system to create uniform records and improve oversight. In the system of social contributions, solutions need to be found in particular in the broadening of the contributions base to other remuneration; this was envisaged in the previous Stability Programme, whereas in the current Stability Programme the policy of social contributions is not clearly defined. Given the rising inflationary pressures, the scope for raising consumption taxes is limited as well. It does, however, seem appropriate to raise excise duties on products with relatively low elasticity of demand (alcohol, tobacco). International comparisons show that a real estate tax is a potential additional source of revenue, but the main reason its introduction is necessary is to improve the functioning of the real estate market. Similarly, in terms of sustainable development it is possible, albeit to a limited extent, to raise the rates of environmental taxes and/or the tax base, which, by sending price signals, could also reduce pressure on the environment.

A trend reduction of the general government debt will be a key challenge for fiscal and other economic policies in the coming years. A key factor affecting the level of debt that can be altered with economic policy measures is credible implementation of the fiscal consolidation programme. The key to achieving that is the carrying out of structural reforms to ensure the long-term sustainability of public finances; as early as this decade pressure on ageing-related expenditure will rise apace with the expected demographic trends. Additionally, debt growth will be influenced by the probable increase in interest rates, whereas the debt problems of several euro area countries render it very likely that bond yields will rise due to a spillover effect in the entire euro area. In the coming years, both these factors will affect the price of Slovenia's borrowing. However, if Slovenia's rating is downgraded due to slow fiscal consolidation and an erosion of financial markets' confidence in the country's commitment to push through with the consolidation measures, it will be even more difficult to secure financing for deficit borrowing and debt refinancing. Moreover, more expensive borrowing would hurt the quality of public finances, as growing expenditure on interest would crowd out the more flexible development expenditure, which could weaken the development role of public finances. Insufficient action in the consolidation of public finances which would lead to a deterioration of the perception of Slovenia's standing by financial markets, would limit access to financing not only for the state but also for the private sector, undermining competitiveness and hampering potential growth. Preserving the current rating is therefore of paramount importance.

Sustainable consolidation of public finances is vital to curbing the general government debt, but it would also have a positive impact on the management of the state's assets and the disposal of the state's equity stakes. We estimate[47] that through ownership shares in companies, the state could buttress the stability of public finances, in particular by improving management, allowing these companies to develop and raise capital and, by extension, boosting the annual income that these assets generate. For this to happen, these companies need to have a more open ownership structure and be given the opportunity to raise capital, but this did not happen last year. The state's withdrawal from direct and indirect ownership of companies and financial institutions came to a complete halt in 2010 – indeed, it was partially reversed – the primary and key reason being that the government does not have a strategy or a clear policy for the management of state equity stakes in companies and financial institutions, hence the preservation or even increase (NLB) of the state's ownership role in the economy. The second reason is the institutional void in this field created by the decision to establish the Capital Assets Management Agency of the Republic of Slovenia, which is not yet fully functional (see Development Report 2011). The scope to reduce debt with the disposal of the state's equity stakes is thus limited; in our opinion, that would be the case even if the mentioned weaknesses are addressed. Companies in which the state has equity stakes include many enterprises performing general public services, which cannot be expected to be privatised. Moreover, several of these are unlikely to attract investor interest and some are already in the process of liquidation. Furthermore, for many companies in direct ownership of the Republic of Slovenia it will be difficult to achieve political

[46] See Economic Issues 2010 for more on the potential for tax increases.

[47] See Economic Issues 2010, Section 8.

consensus over what proportion of its holdings the state should offload. The Exit Strategy objective to reduce public debt by 2 p.p. of GDP by selling state-owned assets is realistic, but in political and economic terms it is not necessarily one that can be easily achieved.

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II.
Impact of the crisis on the labour market and key challenges

Summary

As expected, the economic crisis further affected the labour market in the EU and Slovenia in 2010, with young people, the low-skilled and men being the hardest hit groups. *Owing to the long-lasting impact of crises on the labour market, the unemployment rate increased further in most EU countries in 2010, whereas the employment rate continued to decline. Despite its decline in 2009 and 2010, the employment rate of the 15–64 age group in Slovenia was still above the EU average, whilst the employment rate of older people remains, despite an increase, one of the lowest in the EU. Although the unemployment rate in Slovenia rose more than on average in the EU, it nevertheless remains below the EU average (in 2010, it was 7.3% in Slovenia and 9.6% on average in the EU). In the 2008–2010 period, the situation on the labour market in Slovenia as in the rest of the EU deteriorated the most for men, the low-skilled and young people. The deterioration for men and the low-skilled is to a large extent related to a slump in construction activity. Similar to other countries, in Slovenia the crisis also strongly deteriorated the employment opportunities of young people, which is reflected in a higher rate of unemployment of the young in the 15–24 age group, standing at 14.7% in 2010 (up 4.3 p. p. from 2008). All these groups were also more affected by the crisis in other EU countries. Given the pressing structural problems and an expected delayed effect of the economic cycle on the labour market, the situation is not expected to significantly improve in the short run.*

In 2010, the labour market in Slovenia faced increasing structural problems. *The long-term unemployment rate soared in 2010 (much more than on average in the EU), almost doubling from 2009. It was 3.2% in Slovenia, and 3.8% on average in the EU. The natural unemployment rate also increased during the crisis. Rising rates of long-term and natural unemployment both point to an increasingly structural character of unemployment and thereby to a possible incidence of persistently high unemployment. The second half of the year saw a surge in the number of older and low-skilled unemployed, who have only meagre employment opportunities.*

In 2010, the incidence of temporary and part-time employment increased, along with a persisting problem of segmentation. *A slow economic recovery and rigid labour legislation led to a new rise (after a drop in 2009) in the proportion of temporary employments in total employment in 2010, attaining approximately the 2008 level. Temporary employment is more widespread in Slovenia than on average in the EU, in particular among the young, where the incidence of this type of employment strongly diverges from the EU average. There is less part-time employment in Slovenia than on average in the EU, except for the young. High part-time and temporary employment of young people in Slovenia (high age segmentation) results largely from student work, which would need to be regulated differently, although the Mini-jobs Act was rejected on a referendum. Moreover, there is great discrepancy between the rights stemming from fixed-term and permanent employment relationships, which would need to be evened out in order to diminish the segmentation of the labour market.*

In the 2008–2010 period, growth in wages in the private sector was partly affected by changes in the structure of the employed and a rise of the minimum wage, and partly by the changed economic circumstances. *In 2009, marked by a drop in gross domestic product by 8.1%, most of the private sector activities adapted to the changed conditions by reducing the payments for overtime work and extraordinary payments; this resulted in a marked slow-down of wage growth in the private sector. In 2010, despite modest economic growth, wages rose significantly. This was largely due to a rise in the minimum wage and a "technical" effect of a changed employment structure (huge layoffs of mostly workers with low educational attainment and low wages). Despite the option of a gradual transition to a newly instituted higher level of minimum wage, in the first quarter of 2011 as many as 80% of the minimum wage recipients received the full amount set out by the new Minimum Wage Act; the ratio of minimum wage to average gross wage in the private sector thus rose from 44.2% in 2009 to 50.6% in the first quarter of 2011. A rise in the minimum wage increased wage levelling in the lower end of the wage scale, thus contributing to worsening cost competitiveness; in 2010, the real unit labour costs in Slovenia dropped much less than in the EU. Excluding the above-mentioned effects on wage growth, wages did partly adjust to the changed economic circumstances, except in some activities (in particular those with a high proportion of state-owned enterprises). In these activities, extraordinary payments were high and disproportionate to the business results despite the economic crisis. Thus, one of the challenges of the wage policy remains putting in place more efficient mechanisms that will guarantee that the level of wages and bonuses will be commensurate with business results also in these enterprises.*

The onset of the crisis coincided with the beginning of implementation of the wage reform in the public sector; the first measures limiting wage growth in the public sector were taken in February 2009. *The implementation of the new wage system in the public sector included the disbursement of the first two quarters of funds to eliminate wage disparities, in August 2008 and January 2009, which coincided with the onset of the economic crisis. As a result of an*

agreement on wages in the public sector stemming from changed macroeconomic conditions (February 2009), wage growth in the public sector was already somewhat lower in 2009 than in 2008, and in 2010 wages stagnated. Since 2009, the macroeconomic situation has not allowed the wage reform in the public sector to be completed; two more quarters of funds to fully eliminate wage disparities in the public sector remain unrealised. The measures to keep down wage growth in the public sector have been taken with the aim of urgent public finance consolidation; however, the growth in employment is another factor affecting the efficiency of these measures, as it further picked up in the public sector in 2009 and 2010. The mere freezing of some elements of the public-sector wage system cannot guarantee the long-term sustainability of the expenditures on wages in the framework of public-finance consolidation; also, it cannot serve as the only measure to control expenditures on wages in the long term. The economic policy should thus find – together with trade unions – the solutions that would not involve yearly freezing of wages and postponing of payments of the remaining quarters, but would lead to a more stable wage policy agreement in the period of financial consolidation.

The government responded to deteriorating situation on the labour market in Slovenia in 2009 and 2010 by two intervention acts aimed at preserving jobs, by enhancing active employment policy and changes in the labour market regulation. *In January 2009, the Subsidising of Full-Time Work Act was adopted, which promoted the shortening of working hours instead of lay-offs. At the end of May 2009, the Partial Reimbursement of Payment Compensation Act was adopted, which regulated partial reimbursement of payment compensation to the employees on temporary layoff ("waiting" at home). According to our estimates, on the one hand, the two acts helped ease the consequences of the crisis (they kept down the rise in unemployment) and encouraged enterprises' internal flexibility, but on the other, they probably slowed down enterprises' restructuring process. As the number of people participating in the active employment policy programmes as well as the volume of funds for their implementation rise, there is an increasing need for an independent evaluation of the effects of these programmes. The government responded to the crisis by raising participation in the active employment policy programmes; however, the participation of older people and those with lower educational attainment was below the average in 2009 and 2010. There is also a growing need for an independent evaluation of the effects of the active employment policy, as the number of unemployed participating in the programmes has been increasing. Given the growing structural problems, there is a need for enhanced implementation of active employment policy programmes, which would have to be more targeted at the unemployed with low employment prospects and adjusted to the new structure of the unemployed. As the number of the older unemployed has been rising, it would be necessary to strengthen public works, which have been halved this year. The Slovenian Exit Strategy 2010–2013, adopted by the government, also foresees strengthening of the elements of flexicurity and numerous changes in the labour market regulation (adoption of the Labour Market Regulation Act, Mini-jobs Act, Scholarships Act and amendments to the Employment Relationship Act).*

Labour-market reforms should primarily focus on the key problems and ensure coherence between individual policies. *The two key challenges of the labour market policy are: (i) to reduce the high segmentation of the labour market, which cannot be achieved without a consensus on changes in labour market regulations, and (ii) to adopt a set of measures aimed at boosting employment. The AEP programmes will need to be adapted to a new structure of the unemployed. After the rejection of the pension reform, there is a need for an urgent adoption of an active ageing strategy, which would help raise the extremely low employment rate of the older population and thus improve the long-term sustainability of public finance. However, labour market policy and its reform will not be enough to improve the situation on the labour market. The fiscal consolidation calls for greater consistency of various policies and the subsequent formation of a set of measures aimed at the creation of new jobs. Without a better regulation of the labour market and an active role of the state, there is a threat of a long-lasting and modest job-less growth.*

After the referendum rejection of a large part of the amendments to the labour-market regulation, a consensus needs to be reached on the concept of comprehensive labour-market reforms and their continuation. *A large part of the foreseen legislative changes on the labour market was drafted and passed in the first year of the exit strategy implementation. However, the adoption of three acts (Pension and Disability Insurance Act, Mini-jobs Act and Prevention of Illegal Work and Employment Act) was subject to referendum voting, where they were rejected. This shows that there is no sufficient consensus on the content and the urgency of the labour-market reforms. The reforms implemented so far were designed to increase the flexicurity of the labour market, but they neglected the part increasing flexibility. At least two opportunities were missed for the package adoption of the amendments to the Employment Relationship Act, which would (in the first phase) make the types of employment relationship more uniform in terms of the rights and obligations (including the conditions related to notice periods and severance fees upon the termination of the contract). Further on, a professional and political consensus as well as a consensus with social partners would have to be reached on the continuation of reforms in this area; mere isolated, partial corrections of individual problems will not lead to the solution of the labour market problems. The formation of such a consensus poses a challenge for the entire society.*

Introduction

The economic crisis deteriorated the situation on the labour market despite numerous additional measures, and it will not be easy to ease its consequences in the short term. Dwindling economic activity in 2009 led to lower employment and higher unemployment levels in most EU countries in 2009 and 2010. The analysis of wage movements during the crisis in the EU showed that certain adjustment did take place, but it was not sufficient to prevent a rise in unit labour cost (Arpaia, A. and Curci, N., 2009).[1] Although the economies have shown signs of recovery, dealing with its consequences on the labour market will be a long-lasting process (OECD, 2010). Most EU countries strengthened the implementation of labour-market policy measures and even earmarked more funds for this policy in 2009 and 2010. Numerous countries took additional measures aimed at: (i) stimulating various forms of shorter working hours, which were put in place in 23 countries, (ii) improving job placement and investing in re-training, (iii) reinforcing activation of the unemployed, and (iv) increasing the purchasing power of the unemployed and low pay workers by providing them income support (Carone et al., 2009). As a result of numerous measures taken to ease the consequences of the crisis, employment in the EU dropped less than in the US. Slovenia also adopted two intervention acts aimed at preserving jobs and strengthened the implementation of the active employment policy measures.

This chapter presents an analysis of labour market developments during the economic crisis and the response of the government by its labour market policy in Slovenia. The analysis is presented in three sub-chapters. The first sub-chapter presents the impact of economic crisis and the anti-crisis labour-market policy measures in the EU. The second sub-chapter deals in detail with the labour market movements during the economic crisis in Slovenia; it highlights the key issues of the public sector wage policy and the labour market challenges. The third sub-chapter thoroughly presents and analyses the anti-crisis measures on Slovenia's labour market. It outlines the active employment policy measures, which intensified in 2009 and 2010, and the passive labour market policy measures. Also the implementation of the intervention acts for preservation of jobs is analysed. In addition, some other measures and regulatory changes are presented, which could significantly influence the situation on the labour market and its functioning. The concluding fourth sub-chapter attempts to outline the key challenges and problems of the labour market in Slovenia. The analysis was based on the statistical data published by 31 May 2011.

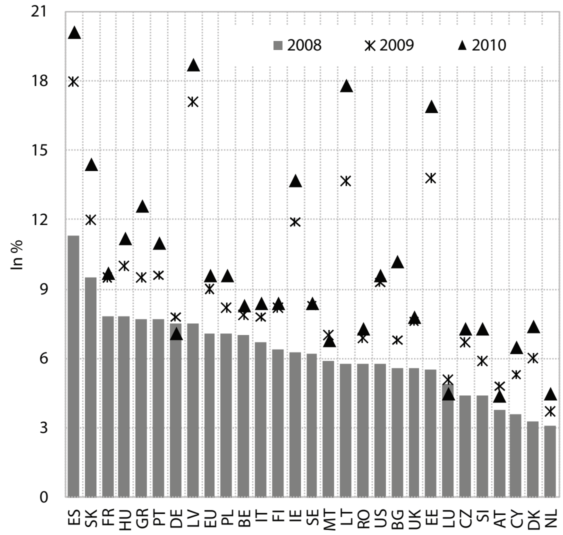
[1] Possibilities for the adjustment of already negotiated wages are limited (variable parts of wages), and the measures promoting shorter working hours encouraged retaining workforce in enterprises (drop in productivity).

1. Economic crisis and its effects on the EU labour market

The deferred effects of global economic crisis were also reflected on the labour market, as the labour-market conditions further deteriorated in 2010. In 2009, the EU labour market responded to the economic crisis by cutting employment; this, however, did not end in 2009. Around 4 million jobs were lost in the EU in 2009 and further 1.3 million in 2010. The employment rate was down 0.4 p. p. in 2010 (and 1.7 p. p. compared with 2008) and stood on average at 64.2%. As a result of persisting effects of the crisis on the labour market and only slow economic recovery, unemployment also rose in most countries in 2010, by 0.7 p. p. to 9.6% (or by 2.6 p.p. compared with 2008). In 2010, unemployment soared the most in the countries that were hardest hit by the debt crisis (Greece, Ireland) and the countries in which the situation on the market remains critical due to the crisis (Spain, Bulgaria, Baltic states). In Spain, the unemployment rate surged 12 p.p. to above 20% during the crisis, largely owing to structural imbalances and severe problems in construction. In contrast, a drop in the unemployment rate was registered in Germany, Austria and Luxembourg in 2010. In Germany, the key reason for an improvement of the labour market situation was not only the job-centred strategy, but also structural reforms of the labour market[2] carried out in the last decade.

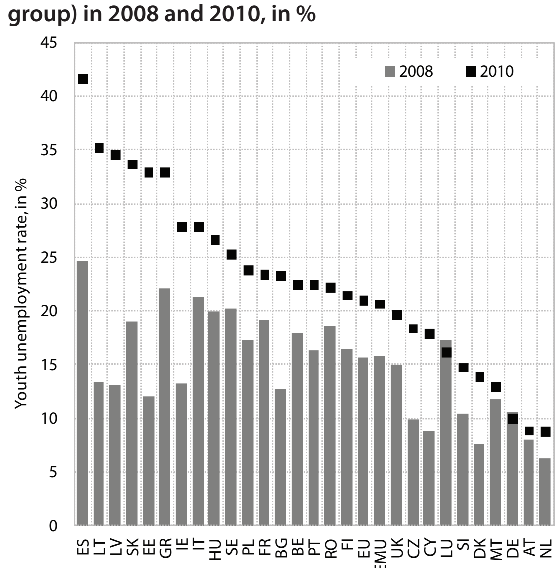
In the 2008–2010 period men were hit harder than women by the worsening situation on the EU labour market, and the employment opportunities deteriorated the most for the young. After the employment rate (15–64 age group) had increased by 1.9 p. p. (to 65.9% in 2008)[3] in the 2005–2008 period, it dropped by 1.7 p. p. to 64.2% because of the crisis in 2009 and 2010. Mostly, the employment rate for men fell, i.e. by 2.7 p. p. in 2010 compared with 2008, while the employment rate for women was down by 0.9 p. p. from 2008 to 58.2% in 2010. In

Figure 1: **Unemployment rates in the EU 2008-2010**



Source: Eurostat.

Figure 2: **Youth unemployment rates (15-24 age group) in 2008 and 2010, in %**



Source: Eurostat.

2010, the unemployment rates for men and women at the EU average level almost converged (9.6%), but were higher for men by 3 p. p. and for women by 2.1 p. p. compared with 2008. The situation on the labour market for men worsened much less in 2010 than in 2009, as the construction activity had declined much more in 2009. The latter also had a notable effect on declining employment of the low-skilled workers. The crisis further deteriorated the employment opportunities of the young (see Figure 2), with the youth unemployment rate strongly rising. In Spain, youth unemployment almost doubled from 2008 attaining 41.6% in 2010; this is also related to a large proportion of young men working in construction.

[2] In 2003, the German government adopted an ambitious reform plan, i.e. Agenda 2010, which also included numerous labour-market reforms. Several sets of reforms were effected (Hartz I–IV), which included the reorganisation of the employment services, introduction of mini/midi jobs, and the merging of unemployment benefits and social assistance. Among others, the reforms brought about a lowering of taxes (e.g. personal income tax) and a lowering of unemployment benefits. In the short term, the reforms led to a rise in unemployment, but in the long run they improved the functioning of the labour market.

[3] In the period 2005–2008, the employment rate for men rose by 1.4 p. p. (to 72.8% in 2008), and employment rate for women by 2.5 p. p. (to 59.1% in 2008).

In the EU, any larger drop in employment was prevented by the labour-market measures aimed at easing the effects of the crisis, which, however, mainly expired in the course of 2010. Although the crisis strongly affected the developments on the labour market in the EU, employment dropped less than in the USA, mostly thanks to comprehensive measures. Labour-market measures taken by the EU Member States accounted for approximately 0.7% of the EU's GDP in 2009, with this value also slightly rising in 2010. A large part of the temporary measures[4] were aimed at raising the purchasing power of the population (e.g. a temporary rise in unemployment benefits) and strengthening the active employment policy; shortening working hours was another widely applied measure. As the consequences of the economic crisis are likely to persist on the labour market for a longer period of time, certain structural reforms will need to be carried out to improve the situation and above all to provide for long-term solutions to the problems.

During the crisis, 23 EU countries applied the measure of subsidizing shorter working hours. This measure largely increased the internal flexibility and allowed the enterprises to retain their employees during the crisis. In addition, the countries often encouraged and in some cases even subsidised additional training for workers with shortened working hours. In Germany, 3% of the workforce was included in this measure in 2009, which later enabled a relatively rapid response of the economy to the strengthened foreign demand in 2010. Other measures included greater access to unemployment benefits and temporary wage compensations (or temporary exemption from paying a part of enterprises' contributions), which is particularly efficient during the time of recovery of an activity. International institutions mostly called for target-orientation and a temporary character of these measures, as they could lead to great imbalances on individual labour markets, were they to be applied for a longer period of time, mostly because of a too slow and insufficient restructuring of enterprises. The role of the active employment policy was also important for improving the situation on the labour market. The education and training programmes for the unemployed, programmes for encouraging employment and job creation and assistance programmes, which were enhanced during the crisis years, will continue also this year. However, the foreseen savings and public-finance restrictions could severely limit the available funds for the continuation of the active employment policy in 2011.

The situation on the EU labour market is not expected to improve notably in 2011. The unemployment rate in the EU persisted at the level of around 9.5% in the first months of 2011. Owing to the accumulated structural problems, no rapid or significant improvement can be expected in the short term. The positive effect of economic recovery will only start to be shown with delay on the labour market, which can be even longer than usual because of shortening working hours. As the situation and the problems differ among the countries, the recovery of the labour market will also be uneven among individual regions and countries, and relatively slow. According to the spring forecast of the European Commission, the unemployment rate is not expected to drop below 9% this and next year.

[4] According to the European Commission data (Employment in Europe 2010), the measures aimed at raising the purchasing power accounted for approximately 0.5% of GDP in 2009 and 2010. Other temporary measures on the labour market represented 0.2% of GDP in 2009 and picked up to 0.3% of GDP in 2010.

2. Trends in the labour market in Slovenia

2.1. Employment

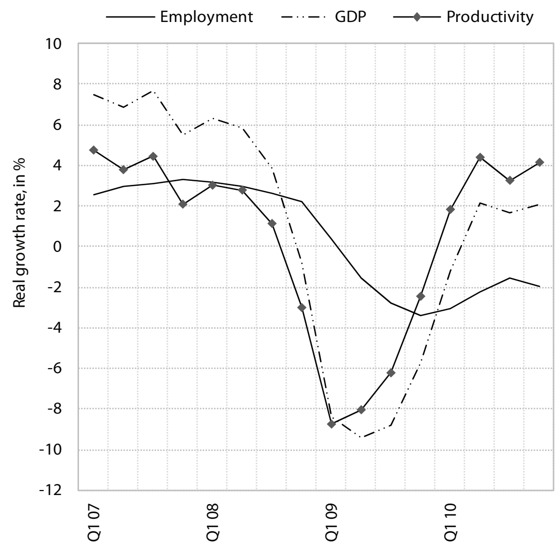
In 2009 and 2010, employment in Slovenia dropped as a result of the economic crisis. The decline in economic activity in 2009 (8.1%, measured as a percentage of gross domestic product) resulted in a decrease in the number of persons in employment across years. To present employment movements, we therefore used data on persons in employment based on the Statistical Register of Employment (see 2.1.1), and the employment rate, an internationally comparable figure provided by the Labour Force Survey (LFS).

2.1.1. Number of persons in employment

The decline in employment,[5] having started in the last quarter of 2008, continued throughout 2010. As in 2009, the number of persons in employment according to the Statistical Register of Employment shrank by an average of 19,000 (2.3%) in 2010. The shrinkage mainly took place in summer, and, even more so, towards the end of 2010. In December alone, it totalled 14,453 (1.8%). In the first quarter of 2011, the decline stopped as a result of seasonal factors, while the seasonally adjusted data show a slowdown. In the first quarter of 2011, the average number of persons in employment according to the Statistical Register remains 2.6% lower on the year-on-year basis.

Employment shrinkage in 2010 is partly due to the fact that labour market movements usually follow positive economic trends with a delay, and partly due to further structural changes, which was also reflected in productivity trends. Over the period between the fourth quarter of 2008 and the second quarter of 2010, the decline in employment slowed and was smaller than the decline in economic activity, which led to a considerable fall in productivity. The recovery of economic growth that followed, however, was too low to bring the fall in employment to a halt. Economic entities continued to adjust (reduce) their employment levels, whereby the productivity growth returned to the pre-crisis level. The slowdown in the decline in employment in the time of the crisis, in particular in manufacturing, was also due to intervention measures in the labour market adopted by the Government in 2009[6] (for more information see Section 3.3). Moreover, the fall in employment is due to further structural adjustments in the economy, as in the period between October 2008 and March 2011 17,777 persons lost their jobs as a result of bankrupcy, accounting for 25% of the total number of employees downsized in the said period of time.

Figure 3: **Year-on-year real growth rates of GDP, employment and productivity (in %)**



Source of data: SORS; calculations by IMAD.

Reductions were mainly recorded in the number of employees, the number of private entrepreneurs is increasing further, whereas in other employment categories the number of farmers and people in informal employment dropped as well in 2010. In the period between October 2008, when it was highest, and March 2011, the number of people in formal employment[7] fell by approximately 70,000 (-8.7%). A decline was also recorded in the number of sole proprietors (-4.9% in the same period of time). The number of individual independent entrepreneurs, having been increasing over the past few years, recorded a 6.3% growth in 2009, and a 3.0% growth in 2010. The reason for this trend is large enterprises' outsourcing of certain works and services to the

[5] This section provides an analysis of the Statistical Register of Employment data which have been collected by SORS on the basis of health insurance applications, and are the most readily available. The Statistical Register of Employment covers people in formal employment (those in a contract-based employment relationship) and the self-employed; it does not cover farmers and various types of informal employment (various types of occasional work, grey economy work, unpaid family workers etc.).

[6] The Partially Subsidising of Full-Time Work Act, OG of RS 5/2009, and the Partial Reimbursement of Payment Compensation Act, OG of RS 42/2009 (for an analysis of these measures, see Item 3.3.), and the measures within the Active Employment Policy programme (programmes of employment, self-employment and public work) (see Item 3.1.).

[7] Persons in a contract-based employment relationship.

Table 1: **Year-on-year rises in the number of people in formal employment by activity, 2008-2010 (in %)**

	2009/ 2008	2010/ 2009	Q1 10/ Q1 09	Q2 10/ Q2 09	Q3 10/ Q3 09	Q4 10/ Q4 09	Q1 11/ Q1 10
Persons in employment according to the Statistical Register of Employment, total	-2.3	-2.3	-0.5	-0.7	-0.7	-0.8	-2.0
Private sector (activities from A to N, from S to T)	-3.5	-3.9	-4.6	-3.4	-2.9	-2.9	-3.5
Public sector (O to R)	2.0	2.0	2.0	2.0	2.0	1.9	0.6
A. Agricultural activities (excluding farmers)	-2.4	-3.0	-3.2	-3.7	-1.7	-3.4	-4.3
B Mining	-7.5	-9.3	-11.2	-9.7	-9.2	-6.9	-3.6
C Manufacturing	-10.1	-5.6	-9.3	-5.9	-4.4	-2.6	-3.1
D. Electricity, gas and water supply	2.9	0.7	2.6	0.8	0.3	-0.9	-2.3
E. Water supply, sewerage, waste management and remediation activities	2.3	1.5	1.9	1.4	1.7	1.2	0.4
F. Construction	-1.3	-9.5	-7.9	-9.1	-9.5	-11.5	-13.3
G. Wholesale & retail trade	-1.0	-2.5	-2.7	-2.1	-2.2	-2.8	-2.8
H. Transport	-2.8	-3.8	-4.7	-3.9	-3.2	-3.2	-2.9
I. Accommodation and food service activities	0.6	-2.4	-0.9	-2.1	-2.9	-3.7	-3.7
J. Informatics	2.8	0.3	-0.1	-0.4	0.5	1.1	1.0
K. Finance	1.0	-0.8	-2.5	-1.9	0.3	0.7	0.4
L. Real estate	4.7	-0.8	0.2	-1.3	-1.2	-0.7	-4.2
M. Professional activities	4.6	4.5	3.9	5.3	5.0	3.9	3.1
N. Administrative and support-service activities	-1.7	3.3	2.1	4.2	4.2	2.7	0.6
O. Public administration	1.1	1.0	1.2	1.5	0.7	0.4	-1.1
P. Education	2.8	3.0	3.0	2.8	3.0	3.0	1.9
Q. Human health and social work activities	2.1	2.1	1.6	1.8	2.3	2.7	1.4
R. Culture, entertainment, recreation	1.8	0.9	1.7	1.1	0.7	0.1	-2.6
S. Other service activities	3.7	1.4	2.5	1.7	0.8	0.5	-1.9
T. Households	7.0	1.1	0.7	1.7	1.1	1.0	0.6

Source of data: SORS; calculations: IMAD.

small business sector. Moreover, self-employment is further encouraged by the state through subsidies for self-employment. In 2010, the number of farmers diminished as well (13.2% according to the SORS estimate) and is expected to rise again in the first quarter of 2011 (24.7% year-on-year).[8] Based on the comparison between the number of people in employment according to the Labour Force Survey and according to employment registers, and the trend in the number of work permits issued to foreigners, it can be concluded that 2010 saw the number of people in informal employment[9] drop slightly, after recording a considerable increase in 2009. The number of foreign workers employed in Slovenia, who accounted for the majority of new hiring in good economic times in 2007 and 2008, keeps falling, having dropped significantly since autumn 2008.[10]

In 2010, the number of persons in employment again dropped, particularly in the private sector, whereas it grew in the public sector. Similarly to 2009, the highest drop recorded in 2010 was in construction and manufacturing. In manufacturing, the decline started as early as in the second quarter 2008. By the end of the first quarter of 2010, the number decreased by 34,000 (-15.2%), whereas between March 2010 and March 2011 it dropped by another 5,800 people (-3.2%). In the period of the crisis, the most significant drop was recorded in the manufacture of metals and metal products, and in the manufacture of clothing, with growth being posted only in the manufacture of pharmaceutical raw materials and preparations. From March 2010 to March 2011, the number slightly rose in some of the manufacturing industries, the highest growth being recorded in the manufacture of leather, whereas the most notable decline was seen in the manufacture of textiles, and in the manufacture of computer and

[8] Due to the previously described methodological constraints, these estimates should be considered with reservation.

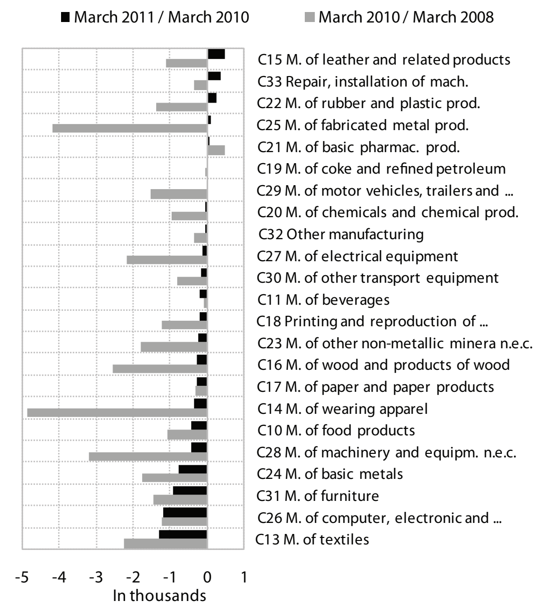
[9] Persons in various types of occasional employment or working in the grey economy.

[10] According to the Statistical Employment Register, the number of foreign employees in Slovenia had increased to 70,327 by September 2008; thereafter, the number was decreasing steadily until December 2010 when it totalled 56,607. Until March 2011, the number of foreigners employed in Slovenia rose again slightly to 57,391. The highest drop was recorded in construction where almost half of the foreigners employed in Slovenia work. Other areas employing foreign workers include manufacturing, transport, distributive trades, hotels and restaurants, professional, scientific and technical activities, and administrative and support service activities.

optical products (see Figure 4). Due to a decline in construction investment, construction was another (and the most important in 2010) area hit by falling employment. In construction, the number of people in employment started to decrease in November 2008, falling by more than 10,000 (-11.7%) by March 2010, and by additional 11,200 in the next twelve months (-13.8%). Other areas witnessing a considerable decline in employment included mining (as a result of the closing down of some mines), agriculture, transport, trade, and hotels and restaurants (see Table 1). In most other services, the number of persons in employment rose in that period. In the private sector, the highest increase was recorded in professional, scientific and technical activities, whereas in the public sector, the increase was highest in education, health and social care. Similar trends on the year-on-year basis by activity continued in the first quarter of 2011 (see Table 1), although the average number of people in employment, compared to the previous quarter, dropped in almost all activities, both in the private and in the public sector.

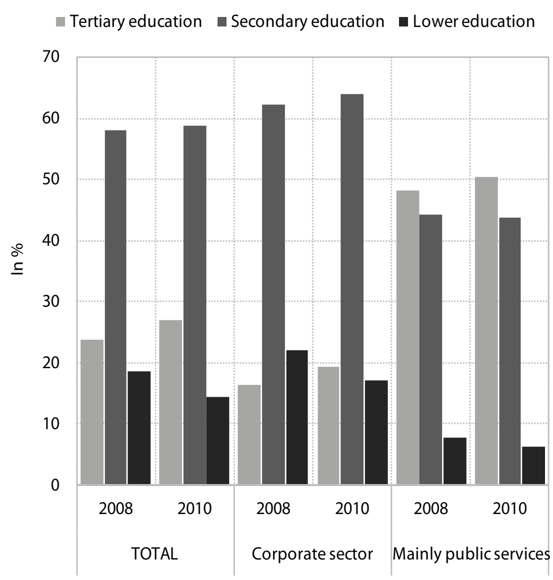
The declining number of people in employment in the period of recession following October 2008 resulted in an accelerated restructuring to the benefit of those with higher average levels of education/qualifications. In the 2006–2008 period, the education structure remained roughly the same, the reason being intense hiring of low-skilled individuals, particularly in construction.[11] In the period of the crisis, the highest drop was recorded in the number of low-skilled employees (in 2010:[12] 12,491, i.e. 9.9%), followed by those with secondary (-3.0%) and higher (-4.7%) education, whereas the number of employees with university and post-graduate education continues to grow. In 2010, it rose by 8,500 (5.5%). The growth was recorded in all activities, the highest levels being reached in education, health care and social services. The most notable decline in the number of low-skilled employees was recorded in construction and manufacturing, whereas the number of employees with secondary education fell the most in construction, trade, manufacturing and transport. As shown in Figure 5, the changes in the education structure of the corporate sector were more intense than in the predominantly public services.

Figure 4: **Changes in the number of people in employment by manufacturing industry group, March 2008–March 2011**



Source of data: SORS; Calculations: IMAD.

Figure 5: **Education structure of persons in employment according to SRE, 2008-2010, in %**



Source of data: SORS; Calculations: IMAD.

[11] In the pre-crisis period, the education level of persons in employment in Slovenia rose only slowly, despite high employment growth and despite the fact that ever better-educated young generations were entering the labour market and considerably less educated older generations were leaving it.

[12] According to a comparison of data for December 2010 and December 2009. The changed methodology for collecting data on the educational level of active population according to the Statistical Register of Employment, introduced in June 2009, does not allow for a closer comparison with the pre-crisis situation.

2.1.2. Employment rate

In the years 2009 and 2010, Slovenia moved away from the EU 2020 target (75% employment rate in the 20-64 age group).[13] By adopting the Lisbon strategy in 2000, the EU set itself a goal of achieving a 70% employment rate in the 15–64 age group by 2010 which, due to the crisis and insufficient reforms, was not reached. The new EU 2020 strategy also preserves the employment rate as a development objective: the new goal is therefore to achieve a 75% employment rate in the 20–64 age group by 2020. Achieving a 75% employment rate is also Slovenia's goal; however, its fulfilment will require a set of measures to create conditions for economic growth that will generate new jobs. In 2010, the employment rate of the 20–64 age group totalled 70.3%, a 2.7 p.p. drop from the year 2008. In the EU, the average employment rate for the above indicated group reached 68.6% in 2010, a 1.8 p.p. drop from 2008.

A decline in economic activity recorded in 2009 interrupted the upward trend in the employment rate. In the 2000–2008 period, the employment rate increased in all age groups (see Table 2). Consequently, the decline in economic activity (8.1%, measured as a percentage of gross domestic product) in 2009 also caused a reduction in the employment rate in 2010, the rate in the 15–64 age group thus lagging behind 2008 by 2.4 p.p. The male employment rate recorded a greater drop than the female employment rate, which is due to a greater decline of activity in activities predominantly employing men (construction, manufacturing).

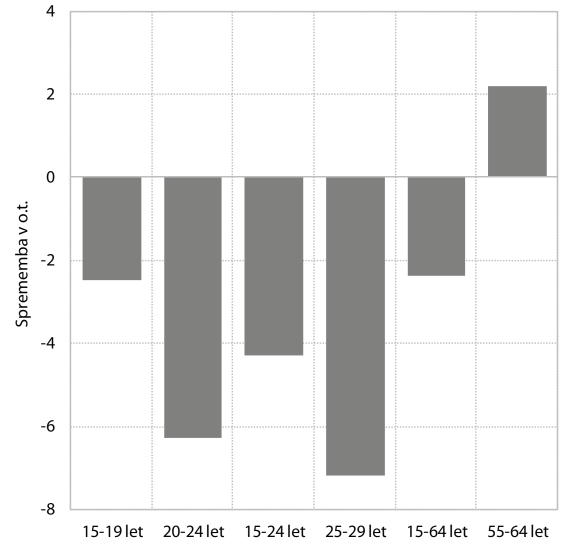
The crisis reduced employment opportunities of the young. Although the decline in economic activity caused the employment rate to diminish in the majority of age groups, the reduction was particularly significant in younger age groups. In 2010, the employment rate of the 15–24 age group was 4.3 p.p. lower than in 2008, whereas in the 20–24 age group, it was 6.3 p.p. lower (see Figure 6). Due to the high share of temporary employment among young people, these were frequently among those employees whose temporary employment contracts were not extended as a result of the economic crisis, while at the same time the demand for student jobs was lower (for details see Section 2.3). The deteriorated position of young people in the labour market is also reflected in the increased unemployment rate of younger age groups (see Figure 10, Section 2.4.)

Table 2: **Employment rate by age group, in %**

	15–24 let	25–54 let	55–64 let	15–64 let
2000	31.2	82.6	22.3	62.7
2001	30.3	83.8	23.4	63.6
2002	31.1	84.1	25.9	64.3
2003	28.6	82.6	22.7	62.5
2004	33.8	84.0	30.1	65.6
2005	34.1	83.8	30.7	66.0
2006	35.0	84.2	32.6	66.6
2007	37.6	85.3	33.5	67.8
2008	38.4	86.8	32.8	68.6
2009	35.3	84.8	35.6	67.5
2010	34.1	83.7	35.0	66.2

Source: Eurostat.

Figure 6: **Changes in employment rate according to age, 2010 and 2008 compared, in p.p.**



Source: Eurostat, calculations by IMAD.

Despite an increase in the period of the economic crisis, the employment rate of older employees in Slovenia continues to be one of the lowest in the EU. In 2010, the employment rate of older people (age group 55–64 years) in Slovenia was 2.2 p.p. higher than in 2008. Although recording a higher increase than the EU average (0.7 p.p.) in the period of the economic crisis, the employment rate of older people in Slovenia is still one of the lowest in the EU.[14] The increased employment rate of the elderly in the period of the crisis is largely due to the effect of a shift in demographic structure and the 2000 pension reform.

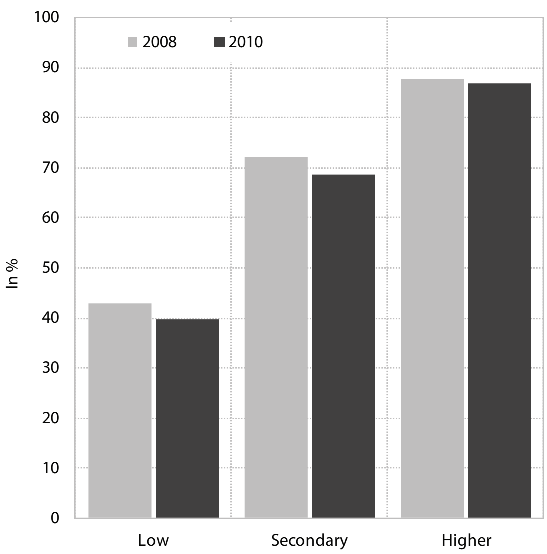
The economic crisis strongly affected the employment opportunities of people with primary and secondary

[13] The working activity rate is the active working population percentage share in the population, capable of work. Its calculation is based on the data from the Labour Force Survey.

[14] In 2010, the only countries having a lower employment rate of the elderly population included Malta, Poland and Hungary.

education. In the 2008–2010 period, the most notable drop was recorded in the employment rate of the low-skilled population, which amounted to 39.7% in 2010, a 3.2 p.p. drop from the year 2008. This is largely due to the significant decline in construction activity. A similar decline was recorded in the employment rate of the population with secondary education, whereas the drop was considerably lower in the group with higher education. Although the number of employed people with tertiary education according to the Statistical Register of Employment increased in the period of the crisis, the employment rate of those with tertiary education dropped slightly, as the number people of working age with tertiary education has been rising faster than the number of people in employment.

Figure 7: **Employment rate by the highest level of attained education, in %**



Source: Eurostat.

2.2. Flexible forms of employment

Temporary and part-time employment is the most frequent flexible form of employment. It typically helps enterprises to adjust more rapidly to changed demand, and it played an important role in labour market adjustments in the time of the economic crisis. Temporary employment covers all types of temporary jobs, and is usually more common in economies having strict employment protection, and an increased level of seasonal work. Furthermore, part-time employment[15] enables employers to adjust to reduced workforce demand, while employees can work shorter hours to reconcile family life and work and for other purposes. In this time of economic crisis, we can expect a reduction in the prevalence of part-time employment and an increased rate of temporary employment, and, in the circumstances of uncertain economic recovery, a rise in flexible forms of employment.

Following the decline in 2009, the share of temporary employment in total employment increased again in 2010. The slowdown and declines of economic activity in 2008 and 2009 caused the share of temporary employees to diminish, given that non-renewal of temporary employment contracts was an important element of reducing employment. Through the gradual and slow economic recovery taking place in 2010, the share of temporary employment rose, almost returning to the level of 2008. In the situation of uncertain recovery of demand and strict layoff rules, enterprises' practice of hiring on a temporary basis is applied more frequently. Nevertheless, the lower level of economic activity in the third quarter of 2010 caused an almost 20% decline in the number of temporary employees over the third quarter of 2008, whereas the estimated number of permanent employees was lower by approximately 7%.

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

	15–24 years	25–49 years	50–64 years	15–64 years
2000	43.2	9.5	6.6n*	12.8
2001	51.0	9.3	4.8n	13.0
2002	52.9	10.8	6.0n	14.6
2003	53.0	10.2	4.4n	13.5
2004	63.1	13.6	7.7n	17.8
2005	62.5	13.5	6.3n	17.2
2006	64.2	13.1	6.5n	17.1
2007	68.3	14.0	6.7n	18.4
2008	69.8	12.7	5.7n	17.3
2009	66.6	12.5	6.0n	16.2
2010	69.6	13.6	6.9	17.1

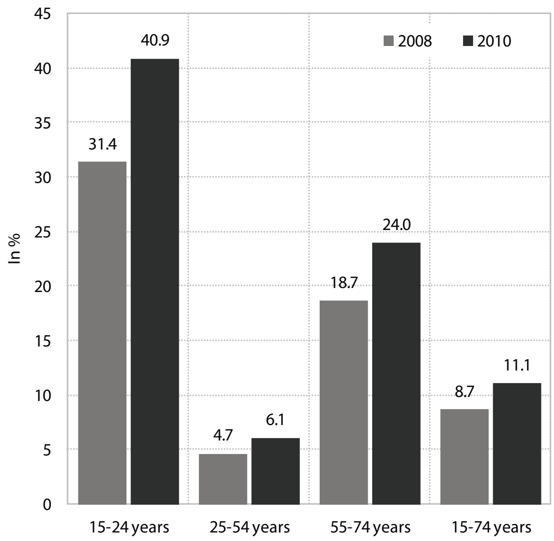
Source: Eurostat.
Note: * n – data not statistically significant.

The highest prevalence of temporary and part-time employment is recorded in the young population group. Table 3 shows that the share of temporary employment is particularly high among people in the 15–24 age group, which carries out most of the student work. A similar trend is recorded in the prevalence of part-time employment in the young population group (see Figure 8). Student work intensifies the extremely strong age segregation of the labour market in Slovenia. In the 2002–2010 period,

[15] In the Labour Force Survey, part-time employment is defined as persons in part-time employment who usually work less than 36 hours a week.

the volume of student work more than doubled. In 2010, student work accounted for about 45% of employment in the 15–24 age group. Excluding work through student employment agencies from the temporary employment of this age group, the share of temporary employment among the young falls considerably, approaching the EU average.[16] This indicates that student work in its current form strongly increases labour market segregation, and should therefore be regulated in a different manner.[17]

Figure 8: **Share of part-time employment in total employment by age group in 2008 and 2010**



Source: Eurostat.

Table 4: **Share of part-time employment in total employment by age group, in %**

year	15–24 years	25–49 years	50–64 years	15–64 years
2000	13.4	3.3	10.0	5.3
2001	15.8	3.3	8.2	5.3
2002	17.6	3.5	8.9	5.8
2003	21.8	3.3	7.9	5.8
2004	29.1	4.4	12.0	8.3
2005	30.1	4.3	9.5	7.8
2006	29.8	4.3	10.4	8.0
2007	29.8	3.9	11.6	8.1
2008	31.4	4.3	9.5	8.1
2009	36.6	5.5	11.0	9.5
2010	40.9	5.9	11.9	10.3

Source: Eurostat.

[16] The share of temporary employment for 2009 calculated in this way accounts for around 42% for the 15–24 age group (EU average: 40.2%) .

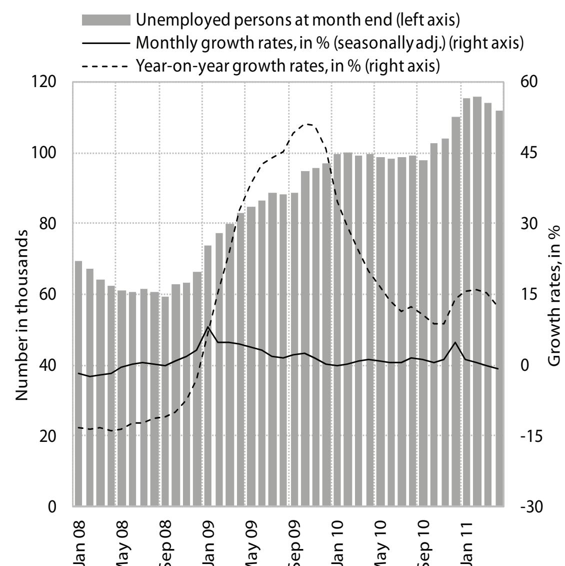
[17] The government tried to regulate this issue by means of the Mini-Jobs Act which, however, was rejected at the referendum and did therefore not become effective (for more details see Section 3.4.)

The share of part-time employment rose in the 2008–2010 period. In 2010, the share of part-time employment in total employment (age group 15–74 years) totalled 11.1%, a 2.4 p.p. increase over the year 2008. Figure 8 shows that the highest increase in the prevalence of part-time employment was recorded in the young population (15–24 years) and in the elderly (55–74 years). The increased prevalence of part-time employment can be associated with the shortening of working hours encouraged by the Subsidising of Full-time Act (for more details see Section 3.3.).

2.3. Unemployment

Under the impact of the economic crisis, the number of registered unemployed has been rising since October 2008. In September 2008, the number of registered unemployed individuals recorded the lowest level in the past decade (59,303). Since that time, the number (also according to the data excluding the seasonal factors) has been rising almost continually due to the economic crisis. In 2010, an average of 100,504 unemployed individuals were registered, an increase of 14,151 persons (16.4%) over the year 2009, and an increase of 37,290 persons (59.9%) over the year 2008. On average, the number of registered unemployed rose at all educational levels, in all age groups and for both sexes. The high increase in the number of unemployed men is largely associated with unfavourable developments in the construction sector.

Figure 9: **The number of registered unemployed at month end, seasonally adjusted monthly growth rates and year-on-year growth rates, in %**



Source: ESS, Seasonal adjustments by IMAD.

The rising number of the unemployed and the declining number of persons in employment caused the unemployment rate to increase in 2009 and 2010. The economic crisis reversed the trend of a falling unemployment rate. The unemployment rate measured by the Labour Force Survey showed a falling trend to the end of 2008. In the third quarter of 2008, it amounted to 4.1%, and the 2008 average was 4.4%, both reaching the lowest values since measurements began. The economic crisis resulted in decreased demand in the labour market: compared to 2008, the number of job vacancies fell by 36.7% in 2009, and remained at the 2009 level in 2010. In 2009, the unemployment rate therefore started to grow, reaching 6.4% in the last quarter of 2009, and amounting to an average of 5.9% in 2009. The rising trend continued into 2010 when the average unemployment rate totalled 7.3%, achieving 7.8% in the last quarter of the year. In addition to the rising number of people registered as unemployed and to the falling number of people in employment, the registered unemployment rate also increased in the 2008–2010 period: from an average of 6.7% in 2008 to 10.7% in 2010. A similar trend was observed in the unemployment rate according to the Labour Force Survey, falling to 4.4% by the year 2008, and rising in 2009 and 2010 under the impact of declining economic activity (see Table 5).

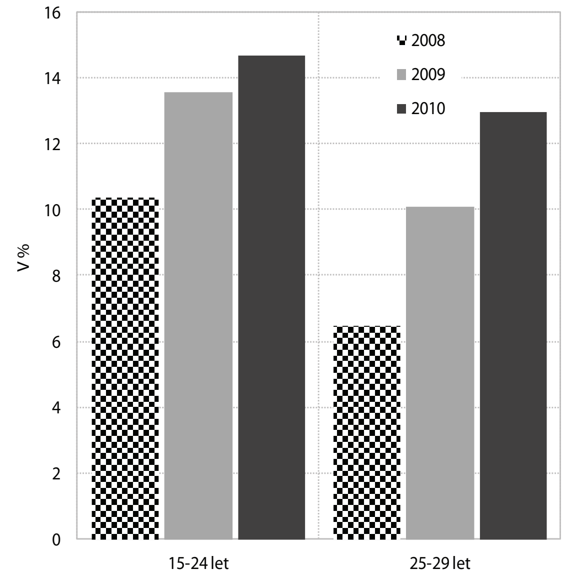
Table 5: **Unemployment rates according to the Labour Force Survey by age, 2000–2010, in %**

year	15–24 years	25–49 years	50–74 years	15–74 years
2000	16.4	5.6	6.5n*	6.9
2001	15.7	4.7	3.8n	5.7
2002	14.8	5.1	3.9 n	6.0
2003	15.3	5.9	3.9n	6.5
2004	14.0	5.3	4.2n	6.0
2005	15.9	5.8	3.9 n	6.5
2006	13.9	5.5	3.5n	6.0
2007	10.1	4.4	3.7 n	4.9
2008	10.4	3.8	3.3n	4.4
2009	13.6	5.5	3.9n	5.9
2010	14.7	7.3	4.4	7.3

Source: Eurostat.
Note: n – statistically non-significant data.

The economic crisis caused the unemployment rate to grow strongly particularly in the young population group. In the 2008–2010 period, the unemployment rate (according to LFS) rose in all the age groups, the increase being highest in the young (see Figure 10). In the last quarter of 2010, the unemployment rate of the 15–24 age group totalled 15.4%, a 4.5 p.p. rise over the last quarter of 2008, whereas in the 25–29 age group, the rate increased by 8.4 p.p. in this period.

Figure 10: **Youth unemployment rates**



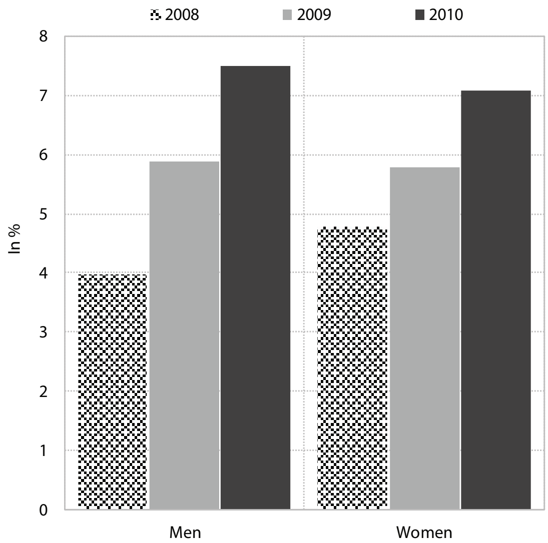
Source: Eurostat.

Similarly, the unemployment rate of young people grew considerably at the level of EU average (see Figure 2). The unemployment of the young is linked to the imbalances in the labour market, arising from the structure of enrolment in tertiary education. On the other hand, the young are very often employed on a temporary/fixed-term basis (see Section 2.3), their employment contracts not being renewed by their employers due to lower demand.

In the 2008–2010 period, the growth of the male unemployment rate exceeded the growth of the female unemployment rate. In 2008, the female unemployment rate (according to LFS) was higher than the male unemployment rate (0.8 p.p.). After a 2.3 p.p. increase (to 7.1% in 2010) in the female unemployment rate (according to LFS) in the 2008–2010 period, and following a 3.5 p.p. growth (to 7.5% in 2010) in the male unemployment rate, the male unemployment rate in 2010 exceeded the female unemployment rate by 0.3 p.p. This is due to a greater decline in economic activity in activities mainly employing men (construction), and is also reflected in the increased share of men among the registered unemployed. Special attention should therefore be devoted to the development of education and training programmes aimed at improving employability of men.

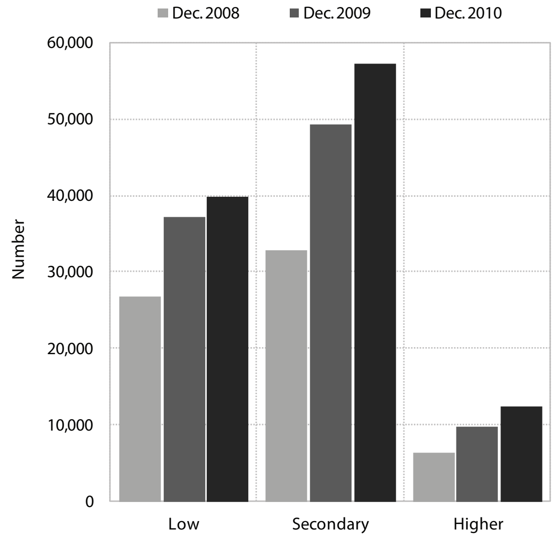
In the 2008–2010 period, the highest relative increase was recorded in the number of registered unemployed with tertiary education, whereas the most numerous group of registered unemployed are those with secondary education. The highest share in the total

Figure 11: **Unemployment rates according to LFS, by gender, 2008–2010**



Source: Eurostat.

Figure 12: **Number of registered unemployed by education level at the end of 2008, 2009 and 2010**

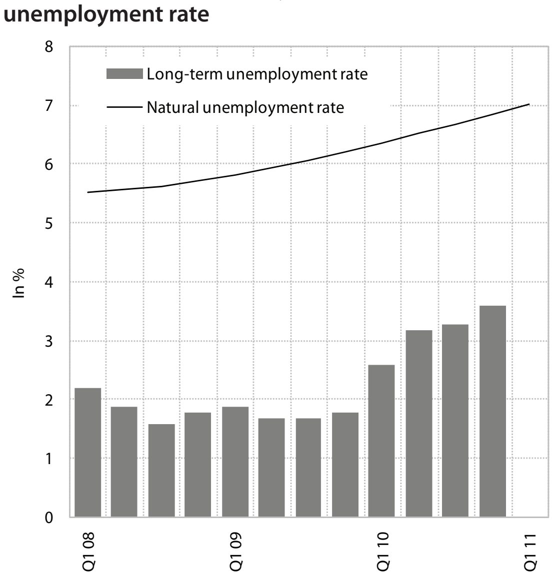


Source: Eurostat.

number of registered unemployed by education is accounted for by the unemployed with secondary education,[18] followed by the low-skilled[19] and by those with higher education.[20] At the end of 2010, the number of registered unemployed was 66.1% higher than in the same period of 2008, with the number of low-skilled individuals being 48.2% higher, the number of people with secondary education 74.4%, and the number of those with tertiary education 98.8%. In the 2008–2010 period, the highest relative growth was therefore recorded in the number of unemployed with tertiary education, suggesting increasing difficulty of the young in entering the labour market, which was reflected in the increased youth unemployment rate (see Figure 10), and a disparity between the supply of and demand for graduates. This is the result of the present structure of tertiary education students enrolled by area of study, which is inappropriate in terms of the labour market requirements (IMAD, Development Report 2010). Decreasing this structural disparity represents a huge challenge for the education policy, whereas the active employment policy is facing the challenge of how to increase the employability of the low-skilled unemployed and the unemployed with secondary education.

In 2010, strong growth was recorded in the long-term unemployment rate, suggesting structural problems. The share of long-term unemployed in the total registered unemployed, having amounted to 51.1% in 2008, dropped to 36.5% in 2009 under the impact of high inflow into unemployment, and rose again to 42.5% in 2010. The growth in the number of registered unemployed who are above 50 years of age and have poor employment opportunities and, consequently, a high probability of transition into long-term unemployment, was particularly strong in the second half of 2010. The growing issue of long-term unemployment is also suggested by the data about the long-term unemployment rate provided by the Labour Force Survey (see Figure

Figure 13: **Natural unemployment rate and long-term unemployment rate**



Source: Eurostat for the long-term unemployment rate, IMAD calculations for the natural rate of unemployment.

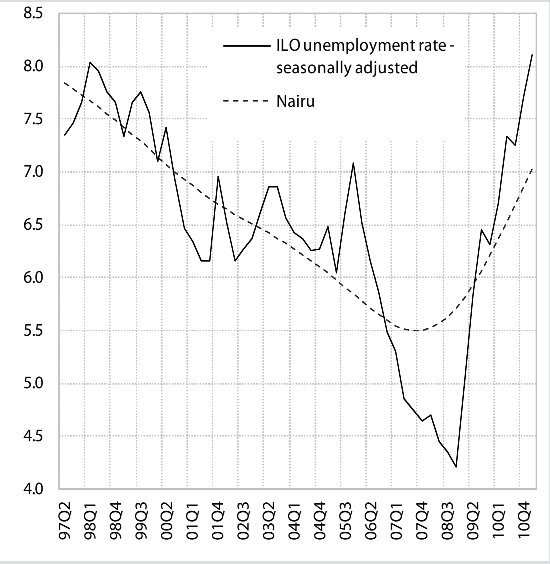
[18] In 2010, an average of 51.5% of the unemployed had a secondary education.
[19] In 2010, an average of 37.3% of the unemployed had a low education.
[20] In 2010, an average of 11.1% of the unemployed had a tertiary education.

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

The calculation of the natural unemployment rate (NAIRU) was based on the univariate method of decomposing unemployment into cyclical and trend components, assessing the model by using the HP filter.

Over the period of time until 2008, the natural unemployment rate had been decreasing and rebounded with the onset of economic crisis. Figure 14 shows that NAIRU had been falling until 2008, reaching the lowest level of 5.5% before the onset of the crisis. Over the next two years, however, the natural unemployment rate started to rise, in the first quarter of 2011 already reaching the level of 2000 (7%). In the period of the economic crisis, the NAIRU was growing in most of other OECD members as well (OECD, 2009). The increase may have primarily been attributed to negative effects of the economic crisis on the labour market, in particular the rising long-term unemployment. As the NAIRU is also impacted by the minimum wage level (Tulip, 2000), the increase in the NAIRU in Slovenia could, according to our estimates, also be attributed to a considerable rise in the minimum wage in 2010 (for details on the minimum wage see Box 2).

Figure 14: **Actual unemployment rate and estimated natural unemployment rate**



Source: SORS; calculations by IMAD.

In the period of high economic growth, the real unemployment rate was lower than the natural unemployment rate. In the period following the third quarter 2006 and extending up to the first quarter 2009, the average real unemployment rate was lower than the natural unemployment rate, the negative difference increasing even further after 2007, which is consistent with the relatively high rate of wage growth and accelerated economic growth based on favourable global economic trends and domestic investment activity. In the year 2009, characterised by a decline in economic activity, the real unemployment rate, however, rose again above the natural rate, with the gap between the two being the widest ever (1.1 p.p.) and still persisting. The time of the gap's closure will mainly depend on the success of reforms on the labour market and those encouraging the economy's competitiveness.

13). After falling in 2009 as a result of high inflow of newly registered unemployed persons, the long-term unemployment rate rose considerably in 2010. In the 2008–2010 period, the increase in the long-term male unemployment rate was higher than that in the long-term female unemployment. In 2010, the long-term unemployment rate for men equalled 3.4%, more than double the level of 2008, whereas for women the rate in 2010 exceeded the level reached in 2008 (2.1%) by 0.8 p.p. The rising long-term unemployment suggests the risk of persistent high unemployment (unemployment hysteresis[21]). According to Ball (2009), unemployment hysteresis is associated with increased natural unemployment, which in the first quarter 2011 exceeded by 1.5 p.p. the level recorded in the first quarter 2008 (see Box 1 and Figure 15). Establishing conditions suitable for the creation of new jobs is therefore one the major challenges faced by economic policy. The rising number of long-term unemployed individuals calls for enhancement of active employment policy programmes to prevent and reduce long-term unemployment (for more detail see Section 3.1.).

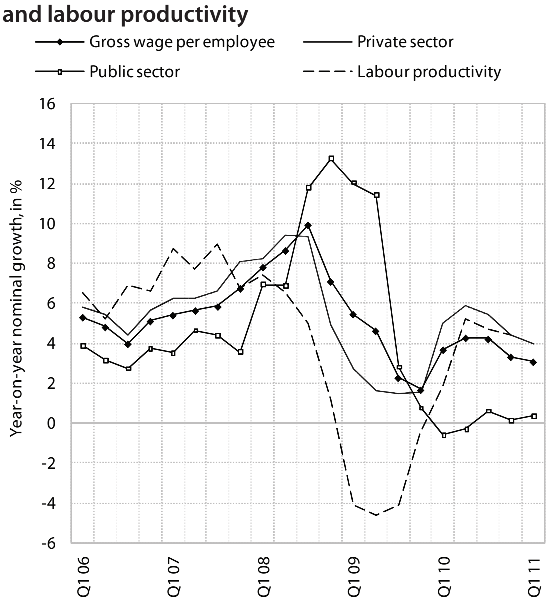
2.4. Wage movements and policy

Growth in wages in the private sector, which was notably affected by a rise in the minimum wage last year, also continued in the first quarter of this year, although at a somewhat slower rate. Due to austerity measures, wages in the public sector stagnated further. In 2010, a rise in the average gross wage per employee (3.9% in nominal terms; 2009, 3.4%) was

[21] The term "hysteresis" originates from the Greek work "hysteros" (later). Most frequently, the term is used in physics, denoting the persistence of an effect after the removal of the cause. In the event of unemployment, it represents the persistence of a high level of unemployment although the recession is already over.

underpinned exclusively by a rise in private-sector wages, as public-sector wages stagnated. Growth in private-sector wages was notably affected by the rise in the minimum wage in early 2010, and partially also by the changes in the structure of employment, and a slight increase in overtime work. Upon the onset of the crisis in the second half of 2008, the relatively high growth in private-sector wages recorded in the previous years was halted, with enterprises responding to the crisis by reducing the volume of overtime work and shortening working hours. This also continued in 2009, when the growth in private-sector gross wage slowed down abruptly. The movements of the public-sector wages were just the opposite: after a relatively slow growth in previous years, growth strengthened in 2008 and even exceeded that in the private sector. The onset of the crisis coincided with the beginning of implementation of the wage reform that had been planned for several years and was intended to eliminate wage disparities among occupational groups in the public sector. This resulted in a relatively strong growth in public-sector wages just after private-sector wages started to slow down. Growth in public-sector wages was already somewhat lower in 2009 (but still substantially higher than in the private sector) as a result of the measures that curtailed growth to a certain extent and brought it to a complete halt in 2010.[22] Stagnation of public-sector wages has also continued this year, whilst wages in

Figure 15: **Nominal growth in gross wage per employee and labour productivity**



Source: SORS, calculations IMAD.

[22] In 2009 and 2010, the government and its social partners signed three agreements, realised with annexes to the Collective Agreement for the Public Sector. Had these agreements not been reached, growth in public-sector wages in 2009 and 2010 would have been similar to that in 2008.

the private sector continued to grow, although at a slower rate than last year.

2.4.1. Wage movements in the private sector

After slowing down substantially because of the economic crisis in 2009, wage growth in the private sector strengthened again in 2010, mostly because of a rise in the minimum wage. Stronger growth in the average gross wage per employee in this sector in 2010 (5.2%) was largely underpinned by an increase in the minimum wage, and partially also by the changes in the structure of employment resulting from layoffs of workers in the lowest income brackets and a slight rise in the overtime and extraordinary payments, and payments in arrears.[23]

Upon the onset of the crisis, growth in wages slowed down to a greater extent and more rapidly in industry than in services, but lately growth in industry has been recovering faster. In all activities, the crisis interrupted growth in wages from the previous years, but the response to the crisis differed across the activities. Growth slowed down to a greater extent and more rapidly in industry[24] than in market services,[25] but it has also recovered faster in industry (also because of the low reference base). Enterprises first responded to the crisis by reducing the volume of overtime work and shortening of working hours, and later on by layoffs and wage adjustments, which were more marked in industry. The general slowdown in the year-on-year growth in wages was first recorded in the last quarter of 2008, when the volume of extraordinary payments dropped and wage growth consequently slowed in almost all activities. In 2009, growth further eased in all activities and in the last quarter of 2009 it was negative or averaged at around 0% in most activities. The average nominal growth in gross wages in this sector thus decelerated to a mere 1.8% in 2009 (from 7.8% in 2008)[26], only to recover in all activities, but with different intensity in the

[23] A rise in the minimum wages contributed around 3 p. p., changes in the structure of employment in the sector around 0.5 p. p. (in 2009, 0.9 p. p.), overtime payments 0.2 p. p., and extraordinary payments and payments in arrears 0.3 p. p.

[24] Industry includes manufacturing, construction, mining, electricity supply and water supply.

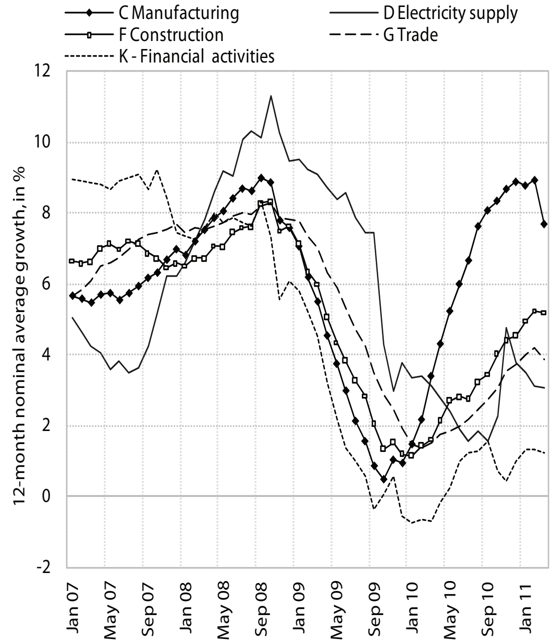
[25] These include trade, accommodation and food service activities, transport and storage, real estate activities, information and communication, financial and insurance activities, professional, scientific and technical activities and other service activities.

[26] Given the considerable change in the structure of employed because of layoffs of those on low wages, it was even higher than it would have been under the presumption of an unchanged structure of employed (0.9%).

first quarter of 2010. The financial and insurance activities, and manufacturing, where the slowdown in wage growth was the greatest during the crisis, recorded entirely different developments after two years of crisis. Growth in wages in manufacturing has resumed to the pre-crisis levels (2010; 9.0%), not only as a result of the rising volume of industrial production and labour productivity, but also because of higher minimum wage and layoffs of workers on low wages. In contrast, growth in wages in financial and insurance activities still lags considerably behind the pre-crisis level, largely as a consequence of lower end-year extraordinary payments (see Figure 18).

Reducing the volume of overtime work was one of the first responses of enterprises to the economic crisis; it bottomed out in early 2009 when it started to slowly increase once more, but has not yet reached the pre-crisis level. The number of paid hours for overtime work plunged by 44.3% in 2009 compared to the year before, whilst it rose again by 15.1% on average in 2010. Thus, the volume of overtime work reached 64% of the level recorded in 2008. The volume of overtime work dropped in all activities in 2009, most of all in manufacturing, accommodation and food services, and financial and insurance activities.[27] Last year, it rose again only in five activities, most notably in manufacturing, whereas it further shrank in mining, construction and other service activities to around 50% of the level recorded in 2008. The shares of payments for overtime work in wages (Table 6) also followed the movements in the volume of overtime work; after they bottomed out in the first quarter of 2009, they started very slowly to rise again. The share of overtime work payments in wages dropped the most in construction and manufacturing, the two activities that saw the largest declines in the number of people in employment and economic activity in

Figure 16: **Growth in average gross wage per employee in selected private-sector activities**



Source: SURS.

Table 6: **The share of payments for overtime work in wages, by activities, in the period 2008–2011, quarterly data**

	2008				2009				2010				2011
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Private sector total	1.6	1.6	1.5	1.2	0.8	0.9	0.9	1.0	1.0	1.0	1.1	1.1	1.1
A Agriculture, forestry and fishing	0.5	0.5	0.5	0.5	0.4	0.5	0.6	0.7	0.5	0.7	0.6	0.6	0.5
B Mining	2.3	2.5	3.3	4.2	2.6	2.0	2.2	1.8	1.5	1.6	1.7	1.9	2.3
C Manufacturing	2.4	2.4	2.1	1.4	0.8	0.8	1.0	1.2	1.4	1.6	1.6	1.7	1.9
D Electricity, gas, steam, air supply	2.0	1.9	2.2	1.6	1.9	1.9	1.8	1.5	1.5	1.5	1.6	1.5	1.4
E Water supply	1.9	1.9	1.9	1.7	1.7	1.7	1.4	1.5	2.6	1.9	1.6	2.4	1.6
F Construction	2.5	2.7	2.8	2.2	1.3	1.8	1.9	1.6	1.6	1.3	1.4	1.4	1.1
G Wholesale and retail trade	0.8	0.8	0.9	1.0	0.6	0.6	0.6	0.8	0.5	0.6	0.6	0.8	0.5
H Transport and storage	1.1	1.3	1.2	1.1	0.9	1.1	0.8	0.8	0.8	0.8	0.8	0.9	0.8
I Accommodation and food service act.	0.7	0.8	0.8	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.5	0.4	0.4
J Information and communication	0.7	0.7	0.7	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.5	0.6
K Financial and insurance activities	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3
L Real estate activities	0.6	0.5	0.4	0.5	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.5
M Professional, scientific and technical act.	0.8	0.8	0.7	0.6	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.7	0.6
N Administrative and support service act.	2.6	2.9	2.8	2.1	1.5	1.9	2.0	1.8	1.9	1.9	1.9	1.9	2.2
S Other service activities	1.0	1.1	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.5	0.6	0.5

Source: SORS; calculations IMAD.

[27] By 60.6%, 40.0% and 38.8%, respectively.

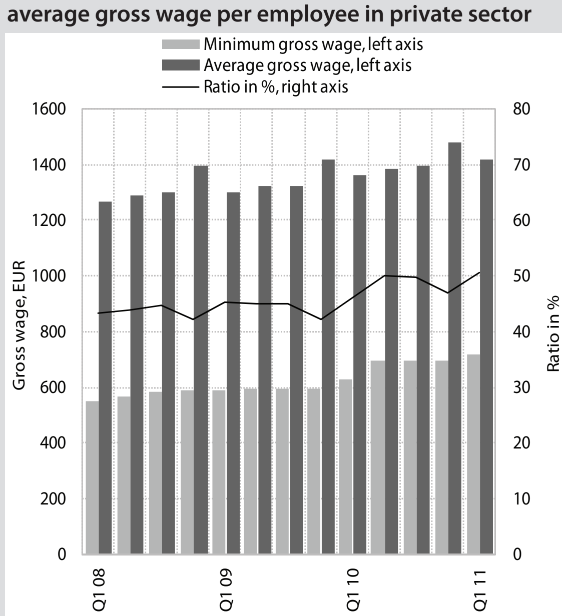
Box 2: **The minimum wage**

In the first quarter of 2011, as many as 80% of the recipients of minimum wage received a new level of minimum wage, with the ratio of minimum wage to average gross wage in the private sector rising from 44.2% in 2009 to 50.6% in the first quarter this year. By March 2010, the new Minimum Wage Act set the level of minimum monthly wage at EUR 734.15, up by 22.9% from the previous level. Given such a high increase, the Act allows for a gradual transition to the new level by 1 January 2012 at the latest. By 1 January 2011, the minimum wage stands at EUR 748.10 or EUR 572.27 in net terms (taking into account general tax relief according to the personal income tax legislation and excluding the potential supported family members). The amount was adjusted for inflation in 2010, i.e. by 1.9% (dec2010/dec2009). In the second year of implementation of the act, i.e. from 1 January 2011 to 31 December 2011, the amount of minimum wage is set at EUR 698.27 (including the adjustment for inflation in 2010) for those employees who agreed with their employer on a gradual transition to the maximum amount, which means an increase by 6.6%. The net amount stands at EUR 539.66. Last year, around 70% of all minimum wage recipients (March to December average) opted for a minimum wage without a gradual transition, whilst in the first quarter this year, this percentage rose to 80%. The average paid out minimum wage thus increased from the last year's average amount of EUR 696 (March to December 2010 average) by 3.3% to EUR 719 in the first quarter this year. As a result, the difference between the average minimum wage in the private and the public sector narrowed. Last year on average, the average paid out minimum wage in the private sector stood at EUR 694, and in the public sector it was EUR 707; in the first quarter this year, these amounts were EUR 719 and EUR 723, respectively. This resulted from a more rapid rise in the number of recipients of the maximum amount of the minimum wage in the private sector (last year on average around 66% and in the first quarter this year, 77%), whereas in the public sector the proportion of the recipients of maximum amount has been high throughout this period (from around 96% last year it rose to 98% in the first quarter of this year). The ratio of minimum wage to the average gross wage in the private sector thus increased from 48.2% on average last year (from March to December, this ratio was 48.8%) to 50.6% in the first quarter this year.

As the level of the minimum wage rose, the number of recipients increased as well. Disregarding slight fluctuation across individual months, the average number of recipients picked up from 42,905 last year (March–December) to 46,740 in the first quarter this year. The number of recipients increased the most in trade (by 1,660) and manufacturing (by 1,440), whilst it even declined in construction in other service activities in the first quarter of this year, most probably due to layoffs. The share of minimum wage recipients in the total number of persons in employment rose from around 7% last year (March–December average) to 7.7% in the first quarter this year. In the private sector, the share of recipients rose from 8.5% (March–December average) to 9.5%, and in public sector, with a much lower number of recipients, from 2.5% to 2.9%.

A high rise in the minimum wage increased the concentration (levelling of wages) at the bottom end of the wage scale and contributed to a worsening of cost competitiveness. The level of minimum wage, also in the case of a gradual transition, stands mostly at the level of the fifth tariff class (jobs for which secondary education is required), compared with the lowest basic and starting wages by collective agreements of activities. The minimum wage is statutorily set as the minimum payment for work under regular working hours, and may thus also include the allowances for special working conditions and efficiency bonuses. This means that these bonuses are not paid out in addition to the minimum wage; if the basic salary together with bonuses equals to (or is lower than) the minimum wage, the minimum wage is paid, i.e. a wage in the amount of the minimum wage regardless of the complexity of job tasks, work conditions and efficiency. The rise in the minimum wage therefore led to a levelling out of wages of a large part of employees at the bottom end of the wage scale up to the fifth tariff class; it also resulted in

Figure 17: **The level of minimum wage and its ratio to the average gross wage per employee in private sector**



Source: SORS. Note: *employees who received extraordinary payments.

the concentration of employees with the minimum wage and close to it, as there was no rise in basic and starting wages according to the collective agreements (except for one collective agreement) because of the higher minimum wage. For this reason, the rise in the minimum wage contributed to a worsening of competitiveness in those enterprises in particular that employ low-skilled workers and manufacture products with low value added. Although the real unit labour costs did drop in 2010, the high wage growth in the private sector (spurred by the increase of the minimum wage) caused this drop to be much lower than in other countries of the euro area and the EU. The formation of an array of measures encouraging structural changes towards higher value-added production and enabling a different distribution and levels of wages is therefore one of the important economic policy challenges.

Table 7: **The level of minimum wage and the number of recipients**

	TOTAL		Private sector		Public sector	
	Number of recipients of minimum wage	Average gross paid out minimum wage, in EUR	Number of recipients of minimum wage	Average gross paid out minimum wage, in EUR	Number of recipients of minimum wage	Average gross paid out minimum wage, in EUR
Jan.10	16,449	597.43	16,018	597.43	431	597.43
Feb.10	17,552	597.43	17,116	597.43	436	597.43
Mar.10	43,323	691.33	38,931	689.77	4,392	705.20
Apr.10	43,566	692.36	39,606	691.00	3,960	705.95
Maj.10	45,213	697.38	41,155	696.42	4,058	707.18
Jun.10	42,590	697.06	38,371	695.94	4,219	707.27
Jul.10	42,898	697.13	38,681	695.95	4,217	707.99
Aug.10	43,384	697.61	39,197	696.47	4,187	708.21
Sep.10	42,517	695.56	38,655	694.29	3,862	708.19
Oct.10	44,218	696.02	40,090	694.79	4,128	707.98
Nov.10	42,299	695.90	38,070	694.53	4,229	708.22
Dec.10	39,041	697.26	34,875	695.93	4,166	708.40
Jan.11	47,738	717.52	43,087	716.98	4,651	722.51
Feb.11	50,314	717.51	45,595	716.99	4,719	722.49
Mar.11	42,168	721.87	37,200	721.79	4,968	722.54

Source: AJPES, calculations IMAD.

general. In manufacturing, the share of overtime work payments has been notably rising again during the last year. In the first quarter of 2011, it almost reached the average value in 2008. In construction, it is still declining, given a new wave of problems.

Extraordinary payments, which are supposed to reflect good business results of companies and function as wage incentives for employees, decreased during the crisis, but in certain activities (predominantly those with a high share of state ownership) much less than would have been expected based on business results and the crisis situation. The total wage bill of extra end-year payments was slightly higher in 2010 than a year before, and accounted for 85% of the level recorded in 2008 (see Figure 18). The level of average payments and the share of employees who received them have always been the highest in the activities with the highest average wages,[28] i.e. in particular in electricity and gas supply,[29] water supply, financial and insurance activities and mining. Such a divergence from the average is surprising, as these are the activities with a predominant share of companies in large state ownership (with oligopolic position on the market) or activities that received abundant financial injections from the state in the period of crisis. For 2011 and 2012, the government adopted recommendations[30] that payments related

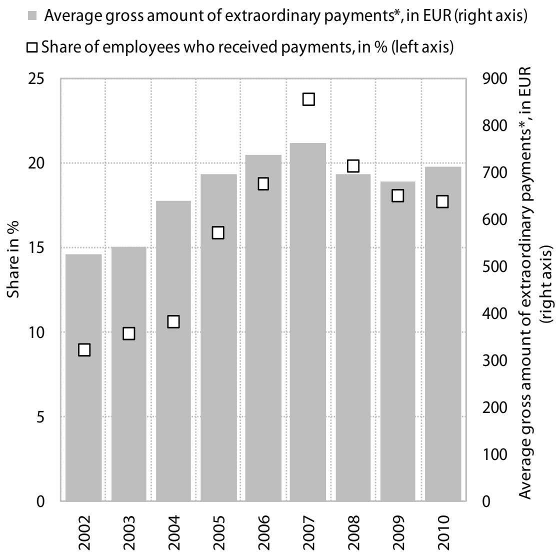
[28] xcept for the water supply, where wages are also higher than the average wage in the private sector.

[29] In November 2010, as much as 91.2% of the employed in this activity received extraordinary payments in the average gross amount of EUR 1,044 (they were higher only in three activities). The share of employed who received payments surprisingly even rose compared to the previous two years, which was recorded only in water supply, whereas in all other activities these shares decreased or remained at the same level.

[30] The recommendations of the government of the RS of 22 July 2010 to the management boards and supervisory boards or boards of directors of companies on wage and other personal income limitations for employees in public corporations and companies performing general public services in direct majority

to business results should not be paid in public corporations and those in direct majority ownership of the state. However, not being compulsory, these recommendations will probably not suffice. Establishing more efficient mechanisms that will also assure the consistency of wages and bonuses with business results in these companies remains one of the challenges of the wage policy.

Figure 18: **The volume of extraordinary payments and wage growth in November, 2002–2010**



Source: SORS.
Note: For employees who received extraordinary payments.

2.5.2. Wage movements in public-sector activities

The years 2009 and 2010 were marked by restrictions on the growth of the gross wage per employee in the public sector, which have continued into 2011. The payments of the last two quarters of funds for the elimination of wage disparities in the public sector have remained unrealised, as after 2009, the macroeconomic conditions have not allowed the completion of the wage-system reform in the public sector. In Economic Issues 2010, we drew attention to the problematic timeline for paying the remaining two quarters, which were to be disbursed in 2011 and 2012. The measures[31] adopted to limit wage growth in this sector slowed the movement of the gross wage per employee in public sector activities in 2009 and 2010, while the additional measures taken lately will also contribute to lower growth in the years to come.

In 2010, a new agreement on measures in the area of wages was adopted, as well as the Act of Intervention Steps. October 2010 saw the adoption of the Agreement on Measures Regarding Public-Sector Salaries and Other Compensation for 2011 and 2012, as well as Annex No. 4 to the Collective Agreement for the Public Sector and the Act of Intervention Steps,[32] postponing the disbursement of the remaining two quarters of funds to a period of more stable economic growth when real GDP growth exceeds 2.5%. An overview of the agreed wage policy components effective in 2010–2012 is presented in Table 8. After the measures reduced significantly the foreseen growth of the average public-sector wage in 2009 and brought it almost to a halt in 2010 and 2011, the 2012 growth will also be much lower than if these measures had not been adopted.

Table 9: **Nominal growth in average gross wage per employee in the period 2008–2012, in %**

	2008	2009	2010	2011*	2012*
Total gross wage	8.3	3.4	3.9	2.5	3.8
Private-sector wage	7.8	1.8	5.2	3.3	4.3
Public-sector wage	9.8	6.5	0.0	0.3	2.5

Source: SORS, IMAD-Spring Forecast of Economic Trends 2011.
Note: *Estimated movement of gross wage per employee

The high growth of public-sector wages, which varied across the activities, slowed down in the times of the government measures, as indicated by the year-on-year developments of wages by quarterly data. A high growth in wages in 2008 and in the first half of 2009 was to a large great extent fuelled by the disbursement of the first two quarters of funds aimed at eliminating wage disparities across the activities under the new wage reform. Growth was highest in health and social care, the activities with the highest corrections of wage levels aimed at eliminating wage disparities. The lowest growth was registered in education and culture. As there is a high share of private sector activity in the culture sector, the public-sector wage reform only partly affected wages in this activity, although it did foresee substantial rises in this

ownership of the state or local communities, their subsidiaries (daughter enterprises) and any further subsidiaries thereof.

[31] Agreement on Measures Regarding Public-Sector Salaries due to the Changed Macroeconomic Situation in the 2009–2010 Period (24 February 2009) and Annex No. 1 to the Collective Agreement for the Public Sector (OG RS, No. 23/09), Agreement on Measures Regarding Public-Sector Salaries for the Period December 2009–November 2011 (28 October 2009) and Annex No. 2 to the Collective Agreement for the Public Sector (OG RS No. 91/09). Besides deferring both quarters of funds for the elimination of wage disparities, the measures tightened the wage adjustment mechanism and temporarily suspended the disbursement of regular performance bonuses.

[32] Agreement on Measures Regarding Public Sector Salaries and Other Compensation for 2011 and 2012 and Annex No. 4 to the Collective Agreement for the Public Sector (OG RS, No. 89/10), Act of Intervention Steps (OG RS, No. 94/10).

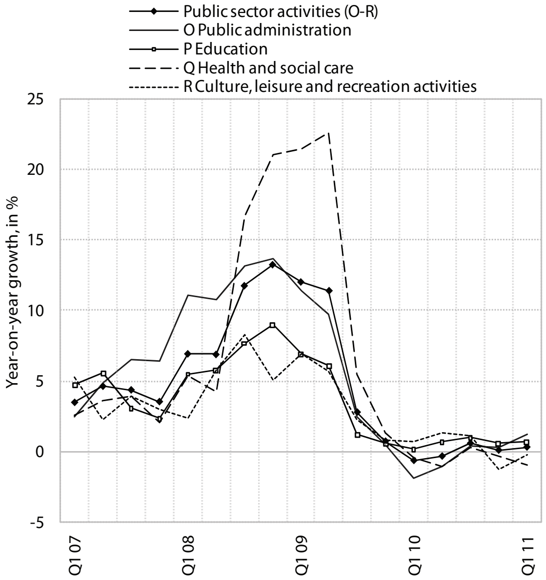
Table 8: **Measures adopted in the area of public sector wages**

Wage policy component	Adopted documents
2010	
January: wage adjustment by 0.2%	Annex No. 2 to the Collective Agreement for the Public Sector (KPJS)
April: regular promotions	Public-Sector Salary System Act (ZSPJS)
July: wage adjustment by half of predicted y-o-y inflation (0.65%)	Annex No. 2 to the Collective Agreement for the Public Sector (KPJS)
October: **NO** payments to eliminate wage disparities (the third quarter of funds not to be disbursed)	Annex No. 4 to the Collective Agreement for the Public Sector (KPJS)
December: performance-related payments **NOT** to be reinstated yet	Agreement on Measures Regarding Public-Sector Salaries for the Period December 2009–November 2011
2011	
January: wage adjustment by 0.55%	Act of Intervention Steps
April: **NO** regular promotions	Agreement on Measures Regarding Public-Sector Salaries for 2011 and 2012
July: **NO** wage adjustment by half of predicted y-o-y inflation	Annex No. 4 to the Collective Agreement for the Public Sector (KPJS)
October: **NO** payments to eliminate wage disparities (the fourth quarter of funds not to be disbursed)	Annex No. 4 to the Collective Agreement for the Public Sector (KPJS)
December: performance-related payments **NOT** to be reinstated yet	Agreement on Measures Regarding Public-Sector Salaries for 2011 and 2012
2012	
January: wage adjustment for inflation exceeding 2%	Annex No. 4 to the Collective Agreement for the Public Sector (KPJS)
April: regular promotions	Agreement on Measures Regarding Public-Sector Salaries for 2011 and 2012, to be reached in 2011
December: reinstatement of performance-related bonuses	Agreement on Measures Regarding Public-Sector Salaries for 2011 and 2012

Source: Annex No. 2 to the Collective Agreement for the Public Sector (KPJS; OG RS 91/2009), Act of Intervention Steps (OG RS 94/2010), Annex No. 4 to the Collective Agreement for the Public Sector (KPJS; OG RS 89/2010), Agreement on Measures Regarding Public-Sector Salaries for the Period December 2009–November 2011, Agreement on Measures Regarding Public-Sector Salaries and other Compensation for 2011 and 2012 (OG RS 89/2010), Public-Sector Salary System Act (ZSPJS; OG RS 56/2002).

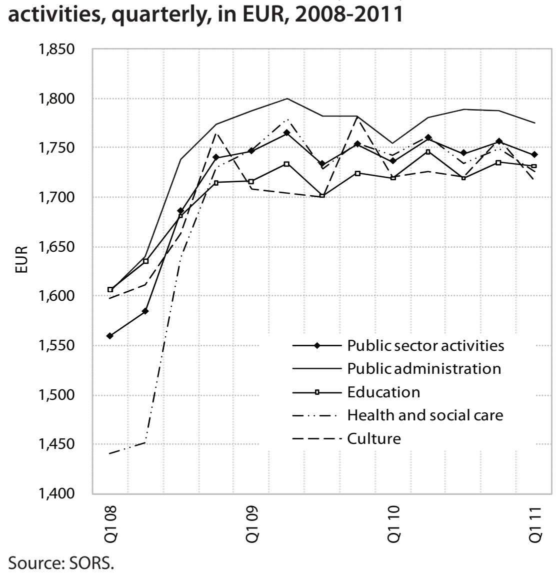
area. After the measures had been taken, growth in the public-sector wages slowed down in all activities. From the fourth quarter of 2009 to the first quarter of 2011, the year-on-year growth roughly stagnated in public-sector activities. After the realisation of the first two quarters of payments aimed at eliminating wage disparities, the results of the wage reform can be seen in converging of the levels of gross wages across the activities, in particular with the rise in the average wage in health and social care; differences, however, remain across the activities in the structure of the employed in terms of education. Whilst the public administration and education activities have quite a similar education structure of employees, the

Figure 19: **Year-on-year nominal movements of gross wage per employee, by public-sector activities, quarterly, 2008-2011**



Source: SORS, calculations IMAD, SCA 2008, public-sector activities from O to R.

Figure 20: **Gross wage per employee, by public-sector activities, quarterly, in EUR, 2008-2011**



Source: SORS.

education structure in health and social care is less favourable (a larger share of employed people with a lower education). The almost equal level of average wages in this activity compared to the other two activities is thus mainly a consequence of a higher share of overtime hours in the wage structure (see Table 10).

In addition to the payment of the first two quarters, other elements of the wage reform also affected wage movements, in particular changes in the valuation of the duty period and new possibilities for paying performance-related bonuses. The share of overtime work in the average wage per employee in public administration increased slightly in the second half of 2008 (as a result of Slovenia's Presidency of the EU in 2008) and in the first half of 2009, only to stabilise at around 1% of the public-administration average wage afterwards. In education and culture, the share of overtime work has been the lowest, constantly accounting for around 0.5% of this activity's average wage. The proportion of overtime work in health and social care, however, strongly diverges upward from the average. In the period 2008-2010, it recorded a strong oscillation (see the table). After accounting for around 7% of the average wage in early 2008, it increased to above 9% in the second half of the year. Specifically, the wage reform brought about a much higher valuation of the duty period (which is included in the overtime work). Holding such a high share, the duty-period pay significantly affected the wage bill. As in the period of restrictions on wage bill growth, the valuation lowered and was adjusted to the current public-finance situation; it was down to 7.9% of the average wage in this sector at the end of 2010. The share of payments in arrears (which include 13th month payments, extraordinary payments and other payments in arrears) in wages is substantially smaller. In public-sector activities, no 13th month payments or payments based on business results were paid out, only extraordinary payments such as performance-related bonuses due to increased workload. The possibilities of disbursing these payments narrowed even further when a temporary restriction on performance-related bonuses due to increased workload was imposed in early 2010. In public administration, the share of payments in arrears in wages stood at around 0.1%. In education and in health and social care, this share picked up from below 0.2% to around 0.5% in 2009. This was mainly a consequence of the wage reform, which, by unifying wage supplements, introduced a supplement for increased workload in all public-sector activities; before the reform, such a supplement had only existed in public administration. As the private sector strongly affects the wage movements in culture, the share of payments in arrears in culture recorded typical private-sector dynamics (a rise in the second and fourth quarter due to performance-related bonuses and 13th month payments).

A strong increase in the public- to private-sector gross wage ratios was followed by the narrowing of the ratio in the second half of 2009 thanks to the measures taken in relation to public-sector wages. The public-to-private sector gross wage ratio always reflects wage movements in both sectors. Thus, a reduction in the ratio in 2010 stemmed not only from the measures taken in relation to public-sector wages but also from a stronger growth in private-sector wages resulting from the new level of the minimum wage (contributing around 3 p.p. to total annual growth). Furthermore, the structure of employees in the private sector has also changed; as the share of low-skilled workers declined, the level of the average gross wage in this sector rose. In 2010, also by international comparisons, this ratio (a 24.2% higher average wage in the public than in the private sector) remains among the highest in the EU (see Economic

Table 10: **Shares of payments for overtime work and share of payments in arrears in gross wage, by public-sector activities, in %, Slovenia, 2008–2011**

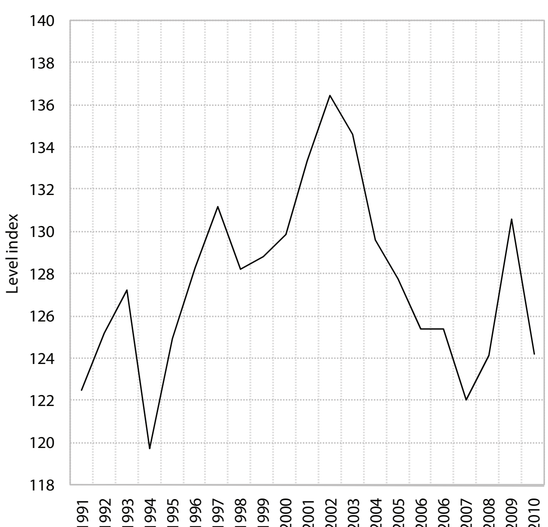
	2008				2009				2010				2011
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Payments for overtime work													
Public administration	1.2	1.3	1.3	1.5	1.5	1.4	1.1	1.1	1.0	1.1	1.0	1.2	1.0
Education	0.5	0.6	0.4	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.4	0.5	0.5
Health and soc. care	6.9	7.0	8.1	9.3	9.4	9.3	8.8	9.0	8.7	8.5	7.6	7.9	7.8
Culture	0.4	0.6	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.4	0.3
Payments in arrears													
Public administration	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.5	0.0	0.1	0.1	0.1	0.1
Education	0.2	0.1	0.3	0.1	0.3	0.4	0.3	0.6	0.3	0.7	0.4	0.5	0.3
Health and soc. care	0.1	0.1	0.2	0.0	1.0	0.5	0.1	0.6	0.4	0.4	0.3	0.6	0.2
Culture	1.0	1.7	1.4	3.4	0.7	1.4	0.7	2.9	0.9	1.4	1.7	2.6	0.7

Source: SORS.

Issues 2010). We estimate that the ratio will narrow in 2011 thanks to the measures adopted this year in the area of public-sector wage movements and that the average level of public-sector gross wages will exceed the level of private-sector gross wages by around 20%. The government measures aimed at keeping a lid on growth in public-sector wages are mainly based on freezing certain elements of the wage system (regular performance-related bonuses, promotion, the remaining two quarters aimed at eliminating wage disparities). Had it not been for these additional measures adopted last October, this year the average wage in the public sector would exceed by around 26% the level in the private sector, according to our estimations.[33] Strong oscillations in this ratio have been present for the last 20 years (see Figure 21). In 1996, an act regulating wage ratios in the public sector was adopted aiming at unification of wages; after that, certain wage supplements were introduced, which again increased the ratio (the 1998–2002 period); then the Public-Sector Salary System Act was adopted in the year 2002, followed by a period of stabilising ratio up to 2008, when public-sector wages actually started to be paid out according to this act, and by a period of crisis-related measures in 2009.

The measures restricting growth in public-sector wages were adopted with a view to an urgent public finance consolidation. The efficiency of these measures not only depends on the movements of the average gross wage per employee, but also on the number of employees. Growth in public-sector employment has not slowed down in line with the parameters of the Slovenian Exit Strategy, as it was up 1.7% in 2009 and 1.5% in 2010 (according to SORS data[34]). The mere freezing of some elements in the public-sector wage system cannot ensure the long-term sustainability of expenditures on public-sector wages within the framework of public-finance consolidation, and cannot be the only measure restraining wage expenditures in the long run. Freezing of all stimulating elements of the wage system (efficiency, promotion) is thus seen as particularly problematic. Moreover, the repeatedly postponed payment of the remaining two quarters only puts off the issue of the final elimination of wage disparities, which will eventually need to be resolved. Simulations indicate that if the remaining two quarters are paid as foreseen, regardless of when this would actually take place, it would lead to a very high rise in wages in the public sector; given the same (or even increased) number of employees in the public sector, this would pose a public-finance problem. It would therefore be necessary, in agreement with social partners, to adopt solutions that would, rather than just freezing wages each year and deferring the payment of the quarters, result in a more stable agreement on wage policy in the period of fiscal consolidation (see also the Fiscal Development and Policy chapter).

Figure 21: **Public- to private-sector gross wage ratios, in %, Slovenia, 1991–2010, private-sector average gross wage=100**



Source: SORS, calculations by IMAD.

[33] Taking into account the estimation of the growth in private-sector gross wage for 2011 from the Spring Forecast of Economic Trends 2011, IMAD.

[34] Monthly Statistical Survey on Earnings is the source of data on employed persons who received wages at legal entities.

3. Labour-market policy measures in Slovenia in 2009 and 2010

The government took measures to respond to the deteriorating labour-market conditions. The government responded to the deteriorating labour-market conditions by extending the implementation of active employment policy measures and passing two intervention acts aimed at preserving jobs. This section presents the active and passive employment policy measures and the assessment of implementation of both intervention acts. Also included is an overview of legislative changes whereby the government has tried to reform the labour market and alleviate some problems that the European Commission has also been highlighting for several years.

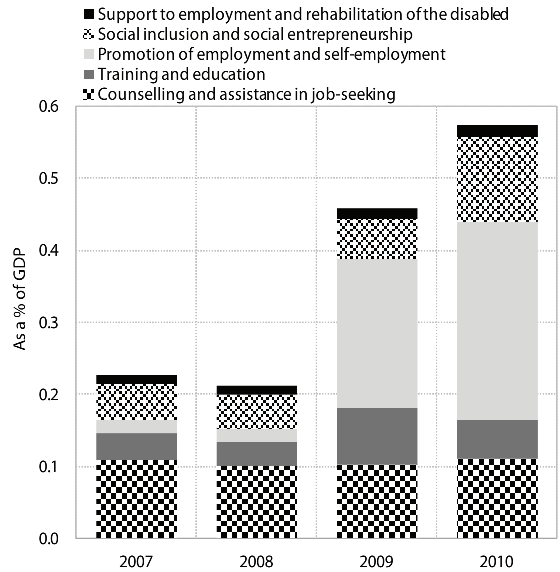
3.1. Active employment policy

The importance of the active employment policy increases in deteriorating labour-market conditions. The purpose of the active employment policy (AEP) is to match the demand and supply on the labour market, reduce unemployment and increase employment, upgrade individual's skills and competences and assist in job-seeking. As mentioned in Section 1, many EU countries, including Slovenia, enhanced the implementation of the AEP during the crisis. Since 2007, the AEP measures and programmes have been carried out in four thematic groups: (i) counselling and assistance in job-seeking, (ii) training and education, (iii) promoting employment and self-employment, and (iv) implementing programmes to boost social inclusion.

The expenditure on AEP programmes increased further in 2010. In 2009, there was a surge in expenditure on AEP programmes, and in 2010 it rose by a further 27.8%. The rise in 2009 and 2010 stemmed mainly from the implementation of the intervention acts aimed at preserving jobs (see Section 3.3.) and enhanced implementation of the AEP. The expenditure on the AEP measures, along with expenditure on the Employment Service accounted for 0.66% of GDP in 2010, up 0.12 p. p. from 2009.

The number of newly concluded contracts for participation of unemployed people in the AEP measures soared again in 2010. In 2010, 77,534 contracts were concluded, which was 25,995 contracts or 50.4% more than in 2009. The distribution of the

Figure 22: **Expenditure on active labour-market policy, as a % of GDP, by programme groups**



Source: MF, calculations IMAD.

participants across the groups of measures was similar to that in 2009; most persons took part in the training and education measures (44.2%), followed by measures encouraging employment and self-employment, and the counselling and job-seeking assistance measures (see Table 11). Compared to 2009, the number of participants increased in all four groups. In the first four months of 2011, 18.2% more contracts were concluded than in the same period last year; the number of contracts increased the most in assistance to self-employment, subsidising self-employment, on-the-job training and "Zaposli.me" ("hire.me") programmes,[35] as well as in institutional training programmes. The number of persons included in public works plunged this year (by one half), which is seen as unfavourable given the increasing long-term unemployment.

The participation rate[36] in the AEP programmes surged in 2009 and 2010, but participation of long-term and older unemployed persons remains low. In 2010, the number of persons participating in the AEP programmes increased by 39.7%, most of all (by 73.5%) in training and education programmes. For the

[35] This programme allows market-oriented employers to gain a subsidy in the amount of EUR 4,000 to employ an unemployed person from the target group – unemployed young people, first-time job-seekers, older, low-skilled or long-term unemployed.
[36] The participation rate is calculated as a coefficient between the number of participants in AEP programmes and the average annual number of unemployed from an individual target group. The participation rate is used only as a partial approximation, as the calculation of the rate is largely under the influence of the changes in the structure of unemployed.

Table 11: **The number of participants in the AEP programmes, in 2009–2011***

	2009	2010	2010/2009 (Index)	Jan–April 2010	Jan–April 2011	Jan–April 2011/ Jan–April 2010 (Index)
Total number of participants	51,539	77,534	150.4	19,915	23,536	118.2
Measure 1: Counselling and assistance in job-seeking	10,859	12,656	116.5	3,895	4,279	109.9
Measure 2: Training and education	20,530	34,296	167.1	8,574	8,035	93.7
Measure 3: Promotion of employment and self-employment	15,355	23,841	155.3	2,534	9,100	359.1
Measure 4: Boosting social inclusion programmes	4,795	6,741	140.6	4,912	2,122	43.2

Source: ESS, calculations IMAD.
Note: *measured by the number of newly concluded contracts.

needs of analysis of the scope and target-orientation of the AEP programmes, we calculated the share of the participants from a certain unemployment group in total unemployment of this group. This serves as an approximate indicator of the participation of an individual group. The overall participation rate of the unemployed in the AEP programmes increased compared to 2009, but the rate of participation of some hard-to-employ target groups rose at a below-average rate, and the share of the unemployed aged 50 and over even declined (see Table 12). The participation rate of the most vulnerable and hard-to-employ groups of unemployed (long-term, less-educated, older and disabled unemployed) thus remains low. It would be necessary to raise the participation of these persons in the AEP programmes and thereby contribute to their better employability and social inclusion. Enhancing AEP programme implementation for preventing and reducing long-term unemployment is an important challenge of this policy.

The funds for AEP programmes in the 2011 budget are lower than in 2010; according to our estimations, they are not sufficient to assure adequate role of the AEP in the strained labour-market conditions. Despite a strong rise in unemployment in late 2010 and a persisting high registered unemployment in early 2011, the foreseen funds in the 2011 budget for the AEP programmes are smaller than last year (-6.7%). This reduction is also a result of the expiry of some intervention measures.[37] These cuts have already led to a smaller scope of some programmes (e.g. public works). The increased interest led to cutting the funds for some programmes at the beginning of the year, so that the Employment Service had to interrupt their implementation temporarily (among others in the programmes of institutional training[38] and national

Table 12: **Number and rate of participation of individual target groups in AEP measures, in %**

Year	Unemployed persons (annual average)					
	No. of registered unemployed	First-time job-seekers	Unemployed for more than 1 year	Less-educated (levels I + II)	Aged 50 and more	Disabled
2008	63,216	10,691	32,334	25,368	21,949	10,603
2009	86,354	12,319	31,487	34,054	26,205	12,199
2010	100,504	14,528	42,750	37,532	31,400	13,839
Number of participants in the AEP programmes						
2008	27,593	4,712	4,121	4,464	3,201	1,357
2009	49,275	6,099	4,316	8,719	4,654	1,921
2010	68,827	7,898	8,116	10,341	5,555	2,674
The participation rate in the AEP programmes (in %)						
2008	43.6	44.1	12.7	17.6	14.6	12.8
2009	57.1	49.5	13.7	25.6	17.8	15.7
2010	68.5	54.4	19.0	27.6	17.7	19.3

Source: ESS, calculations IMAD.

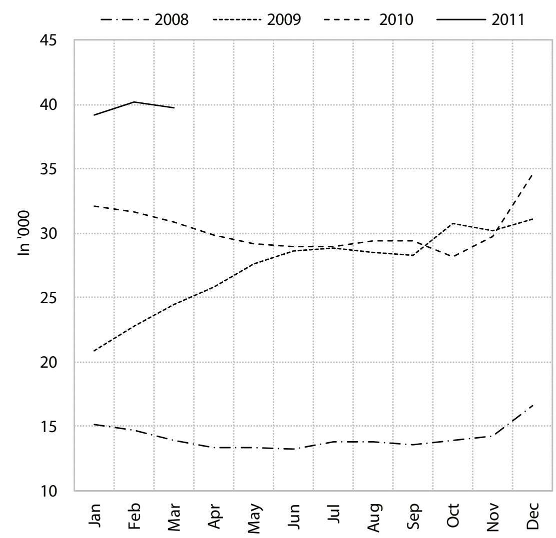
[37] In September 2010, payments of the subsidy according to the Subsidizing Full-Time Employment Act stopped, and in March 2011 also the Act on Partial Reimbursement of Wage Compensations expired.
[38] The purpose of the programme was to gain additional knowledge and skills to use on the job (e.g. language, computer courses, obtaining of a driving licence, training in accounting, preparations for professional examination on general administrative procedure, etc.).

professional qualification,[39] and in subsidising self-employment[40]). If the funds for the AEP implementation are not boosted and its efficiency enhanced, it will not be able to play its role in establishing the conditions for employing of the unemployed and improving the situation on the labour market in 2011. In view of the increased structural unemployment (see Section 2.4), the structure of the programmes would have to be adapted to the new unemployment structure (enhance the programmes earmarked for older and long-term unemployed). It is important that labour market policy also preserve its role in increasing the employability of the unemployed in the period of economic recovery, once the demand for workers is revived and structural imbalances become even more obvious. From this aspect, it is crucial that even in the period of financial consolidation the active employment policy measures are not abolished too quickly, as this could prolong the period of declining employment.[41]

3.2 Passive labour-market policy measures

Soon after the outset of the economic crisis, the number of recipients of unemployment benefits started to rise. Whilst the goal of the active labour-market policy measures is in the first place to accelerate employment, the passive measures are also important, in particular in times of economic crisis. They assure adequate income for the unemployed persons during the job-seeking period. The number of recipients of unemployment benefits started to rise soon after the outset of the crisis and this continued by the early 2010. In the first half of 2010, when unemployment stagnated, the length of the unemployment period increased and the periods of eligibility to unemployment benefits expired, the number of recipients slightly declined, only to bounce again at the end of the year as a result of an increased inflow into unemployment (see Figure 23). From June 2008, when the number of recipients of unemployment benefit was the lowest (13,236 persons) since 2000, to February 2011 it soared by 203.8% (40,207 persons). Until recently, unemployment benefits had been regulated by the Employment and Insurance against Unemployment Act; as a result of legislative changes in the labour market area, the Labour Market Regulation Act started to apply in 2011, regulating unemployment benefits among other things (see Box 3). In addition to the change in the system of rights from the insurance against unemployment, amendments to the Employment Relationships Act were foreseen, with the introduction of the elements of flexicurity being the common goal of all foreseen changes (see Section 3.4).

Figure 23: **Number of unemployment benefit recipients**



Source: ESS.

In 2010, the share of unemployment benefit recipients in the number of registered unemployed declined. After a huge rise in the share of unemployment benefit recipients in total unemployment in 2009, it declined to 27.4% by October 2010, down 5.2 p. p. from the same period in 2009. Cons equently, the average share of unemployment benefit recipients in unemployment in 2010 as a whole also slightly decreased (to 30.1%, down 1.6 p. p. from 2009). At the end of 2010, the share started to pick up again to rise substantially again in the first months this year, which is likely to have resulted from the new act, which raised the level and eased the access to unemployment benefits for certain categories of unemployed persons (see Box 3).

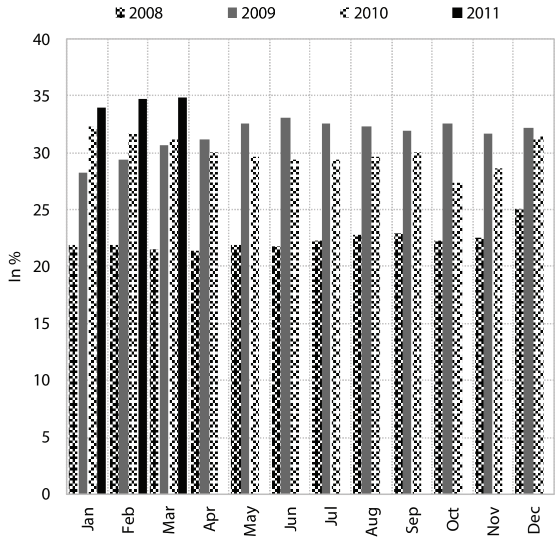
As a result of the rising number of employment benefit recipients, the expenditures on passive employment policy measures also surged in 2009

[39] National professional qualification means obtaining a certificate, whereas basic professional qualification means obtaining a certificate proving competency for performing a certain profession or professional tasks (it does not refer to a level of educational attainment) (e.g. obtaining of a national professional qualification for a security officer or provider of home social care, or obtaining of basic professional qualification of a driver in road transport).

[40] One-off financial assistance in the form of a grant amounting to EUR 4,500 intended as assistance to start-up independent business and realise a business idea; the subsidy can be granted after completing the preparations for self-employment.

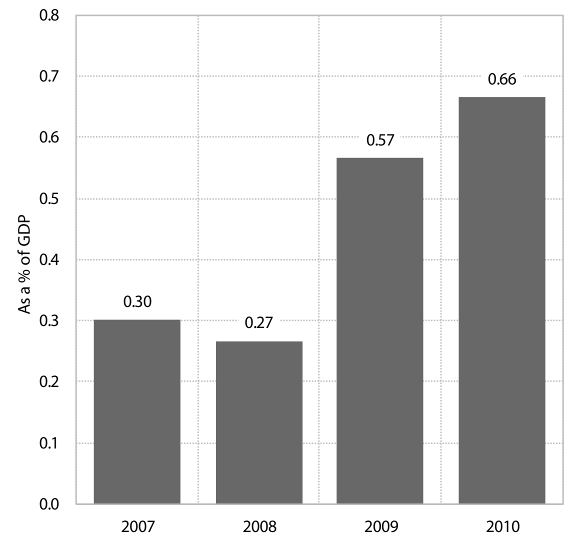
[41] The model simulations for developed countries (G20) indicate that an overly early withdrawal of the employment policy measures could prolong the period of declining employment even up to 2020 (IILS,2010).

Figure 24: **Share of recipients of unemployment benefit in registered unemployment (in %)**



Source: ESS, calculations IMAD.

Figure 25: **Expenditures on passive employment policy in Slovenia, as a % of GDP, 2007–2010**



Source: MF, calculations IMAD.

Box 3: **Labour Market Regulation Act**

The Labour Market Regulation Act replaced the Employment and Insurance against Unemployment Act with the goal of increasing income security of job-seekers and implementing the flexicurity concept. The main aim of the Labour Market Regulation Act (ZUTD), which entered into force at the end of October 2010 and became applicable on 1 January 2011, is to establish a system that ensures an individual suitable employment or vocation and contributes to achieving the highest possible rate of employment. In order to meet these goals, the act also foresees active employment policy measures. One of the main changes introduced by the act is that the circle of beneficiaries to unemployment benefits has been expanded by changing eligibility criteria (an unemployed person who was insured for at least nine months in the last 24 months before the unemployment occurred is entitled to the benefit; in the previous act, this was 12 months in the last 18 months). Furthermore, the level of cash benefit for the first three months is now higher (a rise from 70 to 80% of the assessment basis), with the average monthly salary received by an insured person eight months prior to the month of unemployment serving as an assessment basis. The minimum amount of unemployment benefit is EUR 350 (gross). Social security is increased by the provision that also those insured persons have a right to cash benefit who resign by ordinary or extraordinary termination of the employment contract due to their employer failing to pay their social security contributions for more than six months in the last twelve months. The act also prolongs by one month the period of duration of the unemployment cash benefit for the older insured persons (on the basis of age and achieved insurance period). To help the unemployed stay in touch with the labour market, the act increases the allowed income from work received by unemployed persons (the cash benefit is not reduced if the income from work received by beneficiary does not exceed EUR 200 (net)). Another important novelty is that an insured person who requires no more than one year (in previous legislation, it was no more than three years) to fulfil the minimum conditions for retirement (old-age) upon the expiration of the cash benefit (and is an unemployed person) is entitled to payments of contributions for pension and disability insurance. The latter change probably contributed to a higher inflow to unemployment at the end of 2010. The act also sets out that other job-seekers who according to the provisions of the act do not count as unemployed persons may register at the Employment Service, not only unemployed persons. As the act eases the access to the unemployment benefit, it could increase the number of registered unemployed persons in the short term, but in the long term it will have an important role in providing greater social security to unemployed persons, in particular in the times of economic crisis.

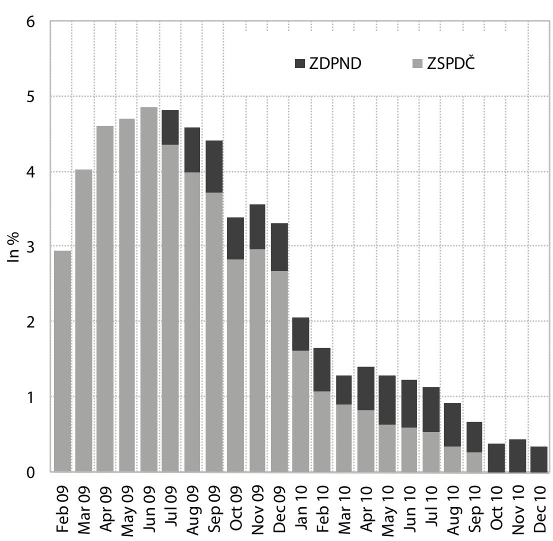
The Labour Market Regulation Act eliminated certain deficiencies in the insurance against unemployment, which we highlighted in Economic Issues 2010, in which we underlined the need for a better regulation of unemployment benefits, in particular the poor income security of the unemployed and limited access of the young to unemployment benefits.

and 2010. The average annual number of recipients of employment benefit soared by 39% in 2009 and by further 10.6% in 2010. The expenditures on passive labour market policy thus doubled in 2009 compared to 2008 and rose by further 19.9% in 2010. As Figure 25 shows, expenditures on passive employment policy surged to account for 0.66% of GDP in 2010.

3.3. Intervention acts aimed at preserving jobs

In 2009, two intervention acts were adopted aimed at preserving jobs. In January 2009, the Partial Subsidising of Full-Time Work Act was adopted, under which enterprises are eligible to a subsidy of EUR 60–120 per month for each employee included in the short-time working scheme. At the end of May, the Partial Reimbursement of Payment Compensation Act was adopted, which regulates partial reimbursement of wage compensations to employees who are on temporary layoff ("temporarily waiting at home"). An employer may place a maximum of 50% of workers on temporary layoff and should pay wage compensation to workers in the amount of 85% of their average wage in the previous three months. The state reimburses to the employer 50% of this compensation. Workers on temporary layoff have a right and obligation to spend 20% of their time on training. Training programmes must be provided by the employer, but are co-financed by the state in the amount of EUR 500 per employee. The Partial Subsidising of Full-Time Work Act expired in September 2010 and the Partial Reimbursement of Payment Compensation Act in March 2011.

Figure 26: **Share of employed people for whom subsidies or payment compensation were paid out in total number of employment, in %**



Source: ESS; SORS, calculations IMAD.
Note: *ZDPND – Partial Reimbursement of Payment Compensation Act, ZSPDČ – Subsidising of Full-Time Work Act.

As the two acts entered into force, enterprises showed great interest in these subsidies. As economic activity slowed and employment shrank in the last quarter of 2008 because of the crisis, the Partial Subsidising of Full-Time Work Act, which was adopted in January 2009, stirred great interest among enterprises.[42] In 2009 and 2010, subsidies for short-time work were approved to 904 enterprises[43] for 65,818 employed persons in the whole period of implementation of the Act. A further slowdown in economic activity in the first half of 2009 also led enterprises to apply for partial reimbursement of wage compensations provided by the second intervention act. Partial reimbursement was approved to 946 enterprises[44] (for 25,066 employed persons). As Figure 26 shows, most subsidies for full-time work were paid out in the middle of 2009, when it was received by 4.8% of persons in employment. Altogether, EUR 33 m were paid for subsidies for full-time work in 2009 and 2010, of which EUR 25 m were paid in 2009, when there was a greater interest in the subsidies. Altogether EUR 27 m were paid for partial reimbursement of payment compensation, which started to be paid out in July 2009 (MLFSA; 2011).

Table 13: **Share of enterprises and persons for whom contracts under the intervention acts were concluded in 2009 and 2010, in the total number of enterprises and employees by activities in 2009**

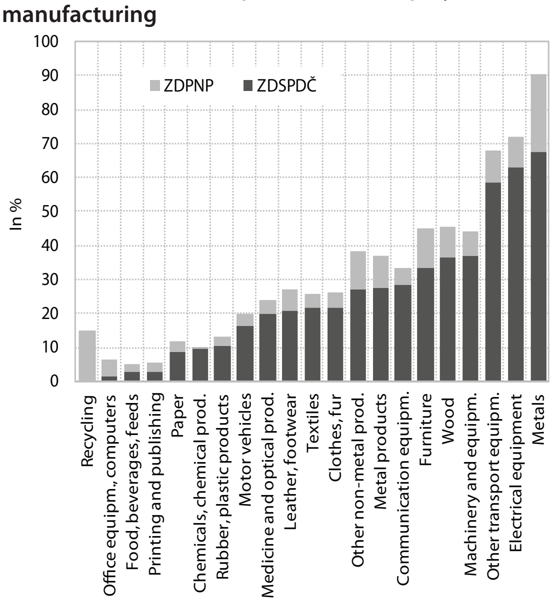
	PRPC		SFTWA	
	Share of enterpris-es, %	Share of persons, %	Share of enterpris-es, %	Share of persons, %
Agriculture, fishing	1.9	1.3	1.0	5.1
Mining	4.4	1.6	1.5	4.4
Manufacturing	4.5	6.7	5	27.1
Energy	0	0	0.5	0.3
Construction	2.7	7.1	1.1	2.7
Trade	1.1	0.7	0.8	1.2
Accommodation and food service	0.9	3.0	1.4	6.8
Transport	0.6	0.8	0.7	13.8
Financial intermediation	0.3	0.8	1.1	2.2
Real estate	0.7	1.6	0.9	2.4
Education	0.7	2.3	1.6	3.8
Health and social care	0.7	0.9	0.8	4.9
Total	1.6	3.8	1.6	12.7

Source: ESS, AJPES, calculations IMAD.
Note: PRPC – Partial Reimbursement of Payment Compensation Act, STFWA – Subsidising of Full-Time Work Act.

[42] Enterprises submitted more than a half of all applications for full-time work subsidies in the first quarter of 2009.
[43] Of which 17% were sole proprietors.
[44] Of which 20% were sole proprietors.

Manufacturing enterprises were the most frequent recipient of subsidies, because of a slump in demand in this activity. As Table 13 shows, 5% of all enterprises in manufacturing applied for subsidies for shorter working time and 4.5% of enterprises for reimbursement of payment compensation. In the total number of recipients of both subsidies, there was the largest proportion of manufacturing enterprises (44%), followed by trade enterprises (18%), enterprises engaged in real estate, renting and business services (16%), construction enterprises (12%), while other activities represent the remaining 10% of recipients of one or the other subsidy. Within manufacturing activities, the metal industry included the largest share of its employees in the two schemes, as shown in Figure 27.[45]

Figure 27: **Share of employed included in the schemes in total number of persons in employment in manufacturing**



Source: ESS; SORS, calculations IMAD.

Small enterprises prevail among the recipients of subsidies. As many as 46% of small enterprises were among the recipients of subsidies, around 4% of large enterprises, around 30% of micro-enterprices, and around 20% of medium-sized enterprises. Although small enterprises prevailed in the total number of enterprises, only 4.0% of small enterprises benefited from subsidising full-time work scheme and 3.3% from partial reimbursement of wage compensation, as Table 14 shows.

Table 14: **Share of enterprises for which contract was concluded under the interventions act in 2009 and 2010 in total number of enterprises, by size of enterprise, in %**

Size of a company (no. of employed)*	ZDPNP	ZDSPDČ
Micro	0.5	0.6
Small	4.0	3.3
Medium-sized	13.3	13.5
Large	17.9	20.9

Source: AJPES, calculations IMAD.
Note: * Micro (0–5 employees), small (6–50), medium (51–250), large (250).

To overcome the economic crisis, some enterprises used both measures. In the overall number of enterprises that received subsidies under the two acts, 9% of enterprises used both measures.[46] The majority of these enterprises were engaged in manufacturing (65%), of which more than a half was from manufacture of metal products, machinery and equipment. Construction enterprises also used both measures (12%) and enterprises engaged in trade, repair of motor vehicles and consumer products (11%). In terms of size, small (37%) and medium-sized enterprises prevailed (30%), whereas micro- and large enterprises held a 17% share.

This section also presents preliminary results of the comparative analysis of business results of the enterprises included in the schemes and other enterprises in 2007–2009. In the first phase of the analysis, we dealt with the business results of the enterprises in the years up to and including 2009, whereas in the coming months, we shall continue with the analysis, including the business results for 2010 and a detailed analysis by activities. The preliminary results at the aggregate level indicate that mostly the enterprises with a larger share of labour cost in value added opted for these measures. These enterprises in particular have better possibilities for internal flexibility (adjustment of the number of working hours).

The return on assets and return on revenues in enterprises that were included in the schemes dropped more than in other enterprises in 2009. Before the crisis, the enterprises that were not included in the schemes recorded lower return on assets than the enterprises included in the scheme, but they recorded a smaller drop in this indicator during the crisis. Also, the return on revenues indicator shows a similar picture. In 2007, the enterprises that were later included in the schemes recorded higher net profit in total revenues, but they became relatively less successful compared to other enterprises in

[45] This analysis did not include sole proprietors, as their annual financial statements are not comparable, or newly established enterprises, which have no statements for the past years.

[46] Of which 9% were sole proprietors.

Table 15: **Comparison of selected indicators of business results of enterprises with and without measures***

	2007		2008		2009	
	With intervention	**Without intervention**	**With intervention**	**Without intervention**	**With intervention**	**Without intervention**
PROFITABILITY						
Return on assets, in %	2.54	1.79	1.49	1.42	0.40	0.67
Return on revenue, in %	1.87	1.76	1.23	1.50	0.44	0.91
DEBT AND SOLVENCY						
Debt as a % of liabilities and capital, in %	69.15	64.67	70.46	66.33	68.97	66.26
Short-term liabilities as a % of liabilities and capital, in %	44.72	46.05	45.38	46.87	42.64	46.23
Capital coverage of fixed assets, in %	73.91	100.95	71.74	99.40	71.53	98.26
Long-term coverage of long-term assets and stocks, in %	90.24	101.79	89.41	100.95	92.01	100.52
EFFICIENCY						
Operational efficiency	1.03	1.02	1.03	1.02	1.01	1.01
LABOUR COST						
Labour cost as a % of value added (in %)	72.84	55.81	74.49	59.86	81.39	63.52

Source of data: ESS, AJPES (statistical data from balance sheet and income statement), calculations IMAD.
Note: *Indicators of business results are calculated using a median company.

2008. In 2009, the year of the crisis, the difference further deepened. The drop in net profit was the most noticeable in manufacturing, transport and storage (in both activities, profits were down already in 2008), construction and trade; these are the activities that profited relatively the most from subsidies and partial reimbursement of wage compensation. Similar trends were also recorded in the cost effectiveness indicator (revenues to expenditures ratio).

The enterprises that opted for the schemes were more indebted before the crisis, but their debt indicators deteriorated less than in other enterprises in 2009. In all three years, the enterprises that did not use the measures were slightly better off in terms of debt indicators, with the share of debt as a percentage of total assets being lower than in enterprises that used the measures. However, the latter enterprises succeeded in reducing the debt more than other enterprises during the crisis. The reason for this was partly a relatively larger reduction of debt in manufacturing and trade and a generally weaker economic activity that resulted in a smaller demand for loans, and (on the other side) also a smaller supply of loans with banks, which faced limited sources of finance and greater risks on the international markets. Despite higher indebtedness, the enterprises that participated in the schemes obtained better maturity terms for their debts, with a smaller share of short-term liabilities in total assets than that of other enterprises. The equity financing of long-term assets was better in the enterprises that did not opt for the measures; despite a greater fall during the crisis, it is still at a higher level than in the enterprises that used the measures.

Although it is too early to make a more precise quantitative assessment of the effects of intervention acts, we can say that the schemes did contribute to easing the consequences of crisis. It is too early to make a credible quantitative assessment of the effects of both acts, as we would need a detailed analysis of flows of employees before and after the implementation of the acts. Based on the available data on the participation of employees, we can say that the two schemes did contribute to an easing of the consequences of the crisis and encouraged internal flexibility in enterprises, but they also postponed the restructuring process of these enterprises.

In the period of economic crisis, not enough was done to increase the employability of workers on temporary layoff. The Partial Reimbursement of Wage Compensation Act imposed on employers an obligation to educate and train their workers on temporary layoff, which would increase employability of these workers. According to the data by ESS (MLFSA; 2011), a great majority of training (90%) of the workers on a temporary layoff took place in the form of internal training, and was carried out by internal mentors or other employees. Internal training most often dealt with production-related technical and technological substances or involved the transfer of knowledge on maintenance of machinery and equipment. The average duration of an individual programme was 72 hours (81 hours for internal training and 63 hours for external training). It is questionable whether the substance of education really contributed to increasing the employability of these employees, as most enterprises organised internal and relatively short trainings. For the last two years, IMAD has emphasised the need for involving the institutions with adequate knowledge in the preparation of education and training programmes for workers on the temporary layoff (e.g. Institute for Adult Education, ESS) (IMAD (2009) – Economic Issues. 2009, IMAD (2010): Economic Issues 2010).

3.4. Other changes in the labour market regulation

The Slovenian Exit Strategy 2010–2013, adopted by the government, foresees (among other things) strengthening the elements of flexicurity and numerous changes in labour-market regulation, which were already been largely implemented in the first year of the strategy implementation. In February 2010, the government adopted the Slovenian Exit Strategy 2010–2013, which should "in the shortest time possible encourage the economic activity and ensure gradual removal of macro-economic imbalances." It sets forth the measures aimed at modernisation of the labour market by revising the key legislation and by merging and coordinating the active employment policy measures, along with increasing the efficiency of the social policy (amendments to the Employment Relationships Act, adoption of the Labour Market Regulation Act, Mini-Jobs Act and Scholarship Act). Some other strategy measures are also related to the labour market, in particular the new Pension and Disability Insurance Act, whose aim was to increase the employment rate of older people, which in Slovenia is one of the lowest in the EU (see Section 2.2), and improve the long-term sustainability of public finance (see the chapter "Fiscal Development and Policy"), the new Minimum Wage Act, whose aim was to enhance social security of recipients of the lowest wages (see Section 2.5 – Box 2), as well as the new Prevention of Illegal Work and Employment Act, whose purpose was to ease the problem of grey economy. A large part of the foreseen legislative changes were drafted and passed in the first year of the strategy implementation. Three acts (Pension and Disability Insurance Act, Mini-Jobs Act in Prevention of Illegal Work and Employment Act) were subject to a referendum and were rejected, which indicates that there is no sufficient consensus on the contents and the urgency of the labour-market reform. Therefore, the continuation of these reforms has also been uncertain, which should be focused on the amendments to the Employment Relationships Act.

Amendments to the Employment Relationships Act (ZDR) should aim at establishing greater flexicurity and should form part of a comprehensive labour-market reform. Changes of the Employment Relationships Act towards greater flexicurity should be carried out in two phases: the first foresees changes that would make the types of employment relationships more uniform in terms of the rights and obligations, including those relating to notice periods and severance pays upon the termination of the contract. The second phase of changes foresees a comprehensive reform of the labour legislation towards greater flexicurity. To be able to reach a consensus on the amendments to the act, a package adoption would be recommended. Thus, the amendments to the Employment Relationships Act should be related to the Minimum Wage Act, which was adopted in February 2010 (see Box 2) and changes in the level of unemployment benefits (in the new Labour Market Regulation Act – see Box 3), whilst the third part of the package could involve establishing a kind of severance fund (as is known e.g. in Austria, but adapted to the situation on Slovenia's labour market). Thus far, only amendments increasing the social security of the employed (higher minimum wage) and the unemployed (higher unemployment benefits and easier access) have been adopted, but not the changes that would increase flexibility. In the future (also because of the rejection of other labour market changes on the referendum), a professional and political consensus as well as a consensus with social partners would need to be reached on the continuation of reforms in this area, as only isolated and partial corrections of individual problems would not solve the labour market problems. Without adjustments encouraging job creation, reducing segmentation and disadvantaged position of the young and curbing the grey economy, the labour market will recover only slowly after the crisis and the key development goals (increasing competitiveness, high employment rates, less social exclusion) will be extremely difficult to attain.

A new Mini-Jobs Act was adopted, which would increase flexibility of the labour market and more adequately regulate student work, but it was rejected on a referendum. By adopting the Mini-Jobs Act, the government wanted to establish more uniform rules on different forms of work that, owing to their temporary nature and dynamics, cannot be considered as being derived from an employment relationship, although in some cases they have the elements of an employment relationship. The aim of the act was to include all forms of such work in the social security system. It more appropriately regulated student work and thus tried to decrease the age segmentation of the labour market, which was also highlighted as a problem in Slovenia (see Section 2.3) by the European Commission. The act also extended the possibility of participating in a temporary work to retired and unemployed people. The act was rejected on a referendum and could thus not be enforced, but the problem of student work will have to be addressed as it negatively affects not only the length of study (by prolonging it) but also the employment opportunities of the young. According to IMAD's assessment, the proposed regulation of student work was appropriate in principle (from the aspect of inclusion in the social insurance system as well as by the restrictions imposed on this type of work). In the future, however, it would be recommended to reconsider the appropriateness of the introduction of mini-jobs for the unemployed. As the act foresaw slightly lower employer contributions for mini-jobs as well as much simpler administrative procedures at hiring and firing, the unemployed could, in our assessment, become caught in a "mini-jobs" trap, as their mini-job could not pass into full employment. In our assessment, and by the experience of Germany, this could lead to new segmentation, formation of new groups of workers for whom mini-jobs would not provide adequate income and social security. Although the proposed regulation of temporary work in Slovenia differed from the German mini-jobs model, some results of the changed labour-market model introduced in Germany in 2003[47] are also relevant for Slovenia. Weinkopf and Kalina (2006) observed that (i) the amount of such "marginal part-time employment" in Germany surged after 2003 and (ii) as many as 85.5% of "mini-jobs" workers are low-wage earners.[48] This is why the future regulation of student work should not be related to any other groups.

After the rejection on the referendum of the new Prevention of Illegal Work and Employment Act, a strategy should be worked out to reduce the scope of grey economy, taking into account that control and punitive policy are important but not sufficient measures to achieve greater progress. Reducing the scope of the grey economy can significantly contribute to greater social security of population, enhance the supply of jobs and thereby the scope of formal employment. Therefore, the new Prevention of Illegal Work and Employment Act was foreseen as one of the measures for improving the labour-market situation. In addition to providing more detailed definitions of illegal work, illegal employment and certain other notions, the new act differed from the current legislation particularly in terms of control and sanctions; it imposed stricter control provisions (expanding the circle of inspection bodies and increasing their competences) and tougher sanctions (higher fines, possibilities for suspension from the pursuit of business, confiscation of equipment for performing illegal work, and confiscation of proceeds from illegal work). There are no reliable data on the scope of grey economy, neither for Slovenia nor in other EU countries.[49] There are different terms describing this type of economic activity ("grey economy", in Slovenia most often "illegal work", "undeclared work", "unregistered work", "informal economy"). The definitions vary as well (in Slovenian legislation, this type of work involves performing an activity by enterprises or sole proprietors inconsistent with the acts defining their activity). As this phenomenon has a number of negative effects (it limits the possibilities of formal employment, with its failure to pay social contributions it negatively affects the social protection system and reduces the present and future social security of an individual, it has impact on illegal migration, etc.), economic policies usually include numerous measures for its restriction. Most often the countries use a policy mix, which in addition to control and sanctioning measures includes deregulation and simplification of administrative procedures related to performing an activity, changes in the tax system, various incentive systems, as well as public opinion campaigns. Also in Slovenia, the problem of reducing the grey economy should be addressed in a more systematic manner and the spectrum of measures should be expanded from permissive to more incentive-related measures. Moreover, it would be necessary to introduce a certain system of incentives for a "conversion" of the illegal work to regulated employment. Some EU countries have already put into practice such incentive systems, i.e. in the area of home help, which has been one of the most widespread types of grey economy. The most known is the introduction of vouchers (Belgium, Austria, Spain) or other forms of subsidizing the price of service (the Netherlands, Denmark), whilst there are also systems of special tax credits or tax relief for payments of home help (e.g. Finland, which has been phasing in the system of vouchers, France). These systems are used for garden work, elderly care, as well as child care, and they involve an increasing circle of users; thereby, they directly contribute to reducing the scope of

[47] In Germany, mini jobs were introduced in the 1960s with the aim of including housewives in the labour market. In 2003 (Hartz reforms), the maximum monthly earning from the mini job was increased from EUR 325 to 400 (no employer's contributions are paid up to this level), the upper ceiling of the number of hours worked per week was abolished (15 hours), and a flexible wage was introduced in the amount of EUR 400-800 for the "midi-jobs".

[48] According to the OECD definition, "low-wage earners" are workers whose earnings are lower than two thirds of the median earning.

[49] In the European Commission's comparative analysis "Undeclared Work in an Enlarged Union", Slovenia is ranked in a group of countries with the scope of grey economy amounting to more than 10% of the GDP. Also other studies generally assess the scope of grey economy in Slovenia to exceed 10% of GDP, and some even 20% of GDP.

grey economy[50] and increasing the scope of formal employment. Given the different assessments of the scope of grey economy in Slovenia, it is also suggested that the methodology of monitoring this phenomenon is defined.

The new Pension and Disability Insurance Act was also rejected in a referendum, although its aim was to alleviate two pressing problems. The new Pension and Disability Insurance Act addresses two issues: the long-term sustainability of public finance and low employment rate of older people (55–64 age group). These are the problems that have also been highlighted by the European Commission for a number of years. The act would contribute to a faster rising of the employment rate of older population, as it increases the qualifying period and the retirement age, as well as financial incentives for staying in activity even once the conditions for early retirement are met; the conditions for men are 60 years of age and 40 years of qualifying period and for women 60 years of age and 38 years of qualifying period. If an individual remains in activity after meeting the early retirement conditions, he/she is entitled to 20% of the level of the early pension each year up to retirement, but by 65 years at the most (Čok et al., 2010). Efficient solutions to these two problems remain one of important challenges of the economic policy.

[50] See: Bringing to the Surface Black and Grey work in Jobs, Labour, Productivity, Finland's priorities for the decade ahead.

4. Challenges

In view of the increasing structural problems on the labour market, which may lead to persistent unemployment, the formation of a policy-mix for boosting employment is one of the major challenges of the economic policy. Should the labour-market regulation not improve and the policies affecting the labour market not become more coordinated, increasing structural problems of the labour market could, in the conditions of a modest economic growth, lead to stagnation in employment and persistent high unemployment in the coming years. As the employment rate dropped in 2009 and 2010, Slovenia fell significantly behind the employment rate of 75% (of the 20-64 age group) targeted for 2020 (the EU 2020 target). In order to reach this target, Slovenia should adopt a set of measures aimed at boosting employment and ensure greater consistency of individual policies, including those that are not limited only to the labour market. The reforms implemented thus far were designed to increase flexicurity of the labour market, but they still neglected the part increasing flexibility. Only isolated, partial corrections of individual problems will not lead to the solution of the labour market problems. After the referendum rejection of a large part of the changes of the labour-market regulation, a social consensus will need to be reached on the continuation and the substance of labour-market reforms, and the measures will need to be designed to address the key labour-market problems.

The problem of high labour-market segmentation is the greatest labour-market policy challenge, which cannot be solved without changing labour-market regulation. In order to diminish labour-market segmentation, (i) the major difference in the rights stemming from fixed-term and permanent employment relationships should be reduced and (ii) student work should be regulated in a different manner. In Slovenia, temporary employment is more widespread than on average in the EU, which is also a consequence of the higher security of permanent employment provided by labour legislation. A high incidence of this type of employment among the young also strongly deviates from the average, which is largely a consequence of the student work. Both problems stem from the current legislation and can thus not be solved without a legislative change.

In view of the structural problems of unemployment, the measures will need to be more adapted to individual target groups of the unemployed. Increasing youth unemployment and the problems of young people entering the labour market are not only a result of the widespread student work and other forms of temporary employment; they also indicate the discrepancy between the demand for and supply of graduates, which is closely related to the tertiary education enrolment structure. The education policy should also be actively involved in addressing this problem (the structure of enrolment in secondary and tertiary education). Extremely low employment rates of the older population (55–64 age group) could also be seen as one of the possibilities for increasing employment rates in Slovenia and thus reaching the EU 2020 target. The number of older registered unemployed people surged in 2010. After the rejection of the new pension act, whose aim was also to increase the employment rates of the older population, boosting employment of older people poses an even greater challenge. In addition to the pension reform, an active ageing strategy should be adopted, incorporating measures in the areas of health and lifelong learning, and those guaranteeing social and income security. It will also be necessary to adapt the programmes of active employment policy to the new structure of the unemployed and to increase the participation of older and long-term unemployed in these programmes.

The consistency of all policies will be of key importance for the improvement of the situation on the labour market, in particular in the period of fiscal consolidation. The active labour-market policy would need to preserve its role in increasing the employability of the unemployed also in the period of economic recovery, once the demand for workers is revived and structural imbalances become even more obvious. It is therefore crucial that the scope of active labour-market policy is not diminished too quickly in the period of financial consolidation, as this could prolong the period of declining employment. Moreover, the fiscal consolidation policy will need to be aligned with the public-sector wage policy; a more stable agreement on the wage policy will have to be reached with trade unions, which would solve and not just postpone the issue of disbursement of the remaining two quarters of payments aimed at eliminating wage disparities, prevent overly high oscillations in wage growth and halt the rising number of employees in the public sector; the latter could also be achieved by streamlining public services and functions and by transferring certain public services to the private sector.

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III.
Impact of the crisis on the credit market in slovenia

Summary

Considering the indebtedness of the Slovenian economy, the impact of the crisis on the financial sector in Slovenia was much heavier than in the euro area as a whole. *This reflects in particular in (i) modest lending activity, which despite a gradual economic revival is not following the upward trend observed in the euro area; (ii) higher active interest rates, which in the case of enterprises and non-monetary financial institutions (NFI) are among the highest in the euro area; (iii) continuing deterioration of the quality of bank assets that forces the banks to create additional reservations and impairments, which worsens their operational results and further inhibits their lending activity; and (iv) a heavy orientation toward household financing above all in 2010 which, however, slowed down considerably this year, pointing to the fact that in a situation of poor capital adequacy banks also have problems lending to clients at low risk rates.*

This situation in the Slovenian financial sector is due to various reasons*. Among the most important is corporate governance in predominantly state-owned banks. The banks' business policy thus (i) focused mainly on foreign debt sources, which – prior to the financial crisis – had been practically unlimited despite their rather unfavourable maturity. (ii) In a time of intense lending activity, the banks paid little attention to the risks and not only financed projects based on their economic viability but also on other reasons. (iii) When results became more favourable, the banks distributed a large share of profits among the owners instead of consolidating their capital adequacy, even though increased needs for capital were expected owing to intense lending activity in the banking system.*

The unfavourable trends in the banking sector restrict access to total assets necessary for growth and development and contribute to "unusual" corporate finances. *This reflects particularly in the unfavourable financial structure of enterprises which both have no liquid financial assets of their own and record a significant share of financial liabilities with shorter maturity, which leads to heavy pressures on their liquidity. A large share of the financial liabilities of enterprises and NFI is represented by bank loans that are only slightly below capital value. Given the ratio between loans and capital, Slovenia's economy is one of the most indebted of the euro area. Loans also have the greatest weight as regards foreign financial sources, whereas foreign direct investments and portfolio investments are much less significant. The underdevelopment of the Slovenian financial system is another factor contributing to the above-average significance of commercial loans taken by Slovenian enterprises among financial liabilities and assets. Moreover, the insufficient payment discipline between companies causes further liquidity pressures.*

The above-average volume of debt sources for financing caused several economic development opportunities to be missed*. (i) During the financial crisis, the offer of debt sources shrank much more explicitly than the offer of equity, which led to lower economic growth than would have been possible with a more normal financial structure. (ii) The relatively widespread state ownership and heavy indebtedness of the Slovenian economy reduce the investors' interests in Slovenian enterprises, which additionally inhibits the deepening of the capital market. (iii) Strong dependence on debt sources for financing enhances the market position of banks, which thus have significant market power given that financial sources are limited. This however does not lead to improved business efficiency, as proved by the rapid deterioration of the situation during the crisis.*

Owing to extensive involvement of the state in the financial sector, risks affect both corporate and public finances*. Difficulties of the Slovenian financial sector are therefore also a systemic problem. It is estimated that the state interventions during the financial crisis were not sufficiently effective. Here, mention is to be made of the slow and insufficient response to the needs for fresh capital in the Slovenian banking system. The state took advantage of the reduced capital adequacy mainly to strengthen its influence although its financial support capacities were rather limited and in the past it had not proved to be an efficient owner. Thus, in the long run, the state has further weakened the financial sector and increased the risks of below-average economic growth in the future.*

Despite a relatively rapid government response in providing liquid assets to banks and taking over a certain part of the risks in the financial system, the situation continues to deteriorate in 2011, also due to the inadequate response regarding bank capital injections. *Additional risks for the Slovenian financial system include the possible worsening of the rating of the state, further reduction of the ratings of Slovenian banks, and the expected lower results of stress tests of Slovenian banks.*

Introduction

In 2010, lending activity in the euro area began to gradually intensify although Slovenia did not follow such trends. There are significant discrepancies in the financing of enterprises and non-monetary financial institutions[1] (NFI) by the banks. This could be attributed to the fact that for Slovenian banks the sources for financing are still very limited and the banks are not willing to take any new risks, while the demand for corporate credit is low owing to the weak economic activity and relatively high indebtedness. If lending activity is limited either in offer or demand (owing to indebtedness), there is a risk that in the expected revival of the economic activity there will not be sufficient funds available to enterprises to increase their business; moreover, their capacity to service the debts will be rather low, which might give rise to pressures on the financial system and the competitiveness of the Slovenian economy and slow down the narrowing of the gap behind the most developed countries.

This part of Economic Issues focuses on trends related to the financing of the Slovenian economy.[2] The first section deals with the trends on the credit markets in the euro area and in Slovenia. The second provides a more detailed analysis of corporate borrowing and structure and the third presents bank sources for financing, which constitute the most important factor of lending activity. The fourth section provides a risk assessment of the worsening of the situation on the credit markets, while the final section presents the existing challenges.

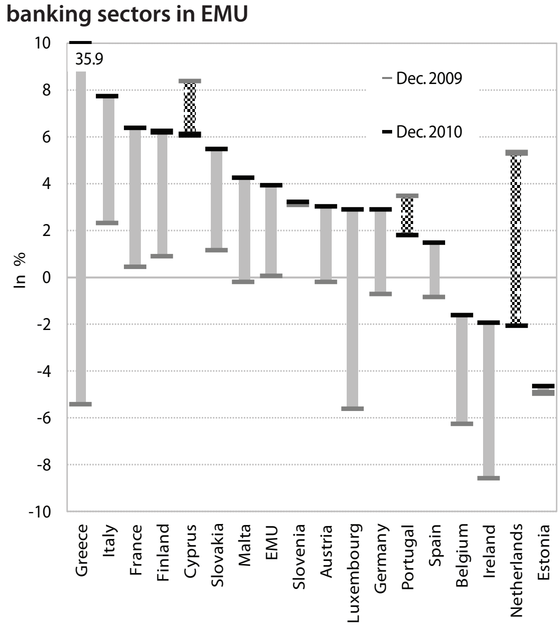
[1] Including financial holdings.
[2] The analysis includes data published before 2 May 2011.

1. Credit market trends

1.1. Credit market trends in the euro area

A comparison of the year-on-year growth rates of loans to non-banking sectors places Slovenia among the very few euro area members where the situation in 2010 further deteriorated. *In addition* to Mediterranean states (Spain excluded as it has to deal with heavy indebtedness), above-average growth rates[3] were also recorded by Finland and Slovakia. According to ECB data, the highest growth among the countries of the euro area was achieved by Greece, which is rather surprising given its current economic situation, particularly because a large share of such growth was due to increased loans to households, and enterprises and NFI. This is a consequence of the structural shift in June;[4] without that, it is estimated that the growth of loans in Greece would be slightly below the euro area average.

Figure 1: **Year-on-year growth rates of loans to non-banking sectors in EMU**



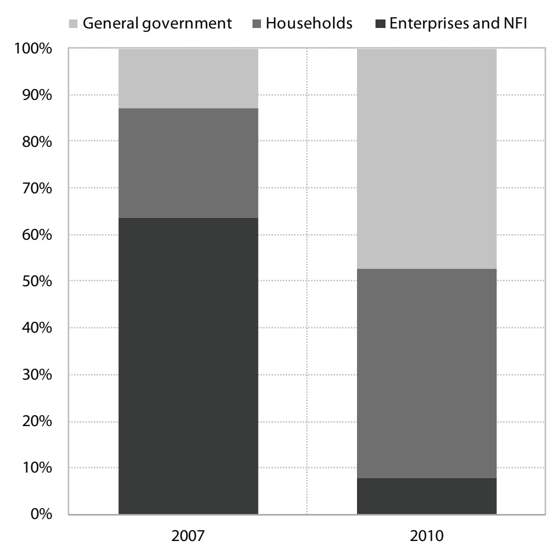
Source: ECB, BS; calculations by IMAD.

Following a period of stagnation in 2009, the volume of loans in the euro area increased by nearly 4% in 2010 (by just over EUR 460 bn), which is slightly below the 2008 level. Contrary to Slovenia, the greatest contribution to the growing loans to non-banking sectors was made by state sector borrowing, mainly

[3] Growth rates above the euro-area average which was 3.9%.
[4] The reasons for such shift have not been identified.

in the largest countries (Germany and France) as well as in certain countries facing heavy indebtedness (Greece, Ireland, Spain and Italy). As a result of the unstable situation on financial markets, banks in 2010 concentrated on safer investments. They intensified general government borrowing and, parallel to higher budgetary deficits, significantly strengthened demand for such sources of financing. Nevertheless, considering the volume of loans, the government is one of the less important sectors. Its loans in Slovenia account for only 3.6% of all loans, while in the rest of the euro area such share reached almost 10%. The relatively low share of the government in the total volume of loans could be attributed to increased borrowing based on securities, which governments find cheaper than the classic bank loans,[5] enabling them to borrow on a longer run. A slightly more modest contribution was made by household borrowing while corporate and NFI borrowing was limited.

Figure 2: **Structure of loans to non-banking sectors in EMU**



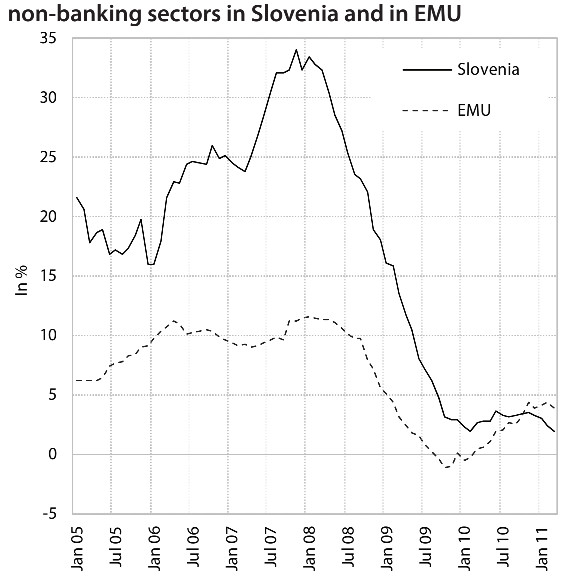
Source: ECB, BS; calculations by IMAD.

Despite a simultaneous slowdown of domestic banks' loans to enterprises and NFI in both the euro area and Slovenia, differences may be observed as regards the revival in lending activity. In 2010, the situation on the credit markets in the euro area slightly improved. Loans to enterprises and NFI began to increase again in the third quarter of 2010 at a growth rate exceeding the growth of comparable loans in Slovenia, although in the euro area as a whole such loans are a much less important source for corporate financing than in Slovenia.

1.2. Credit market trends in Slovenia

In 2010, lending activity intensified slightly compared to the year before, mainly as a consequence of the significant increase of household borrowing and to a lesser extent government borrowing, while in the business sector borrowing continued to slow down. For the first time since comparable data have been available,[6] loans to domestic non-banking sectors grew more slowly than in the euro area as a whole. In 2010, banks granted loans in the total amount of EUR 1.1 bn (a fifth more than in 2009), with over 80% of net flows attributed to household loans. Lending activity cooled down considerably in the second half of the year when the volume of non-performing claims in the banking system began to decrease more rapidly. Banks thus resorted to creating impairments which caused additional pressures on the availability of bank assets and lending activity.

Figure 3: **Year-on-year growth rates of bank loans to non-banking sectors in Slovenia and in EMU**



Source: ECB, BS; calculations by IMAD.

The lending activity of Slovenian banks remained low despite the guarantees adopted in 2009 and 2010. Between June and December 2009, banks recorded lending to enterprises and natural persons in the amount of EUR 605.1 m based on a guarantee scheme, but drawing decreased by almost 60% in 2010. A considerable share thereof was attributable to corporate borrowing, yet only about 40% of the guarantee scheme was used. Even less advantage was taken of the guarantees for natural persons (under 15%). It is estimated that a large share of loans given

[5] Due to better liquidity, investors require lower yield.

[6] Since 2005.

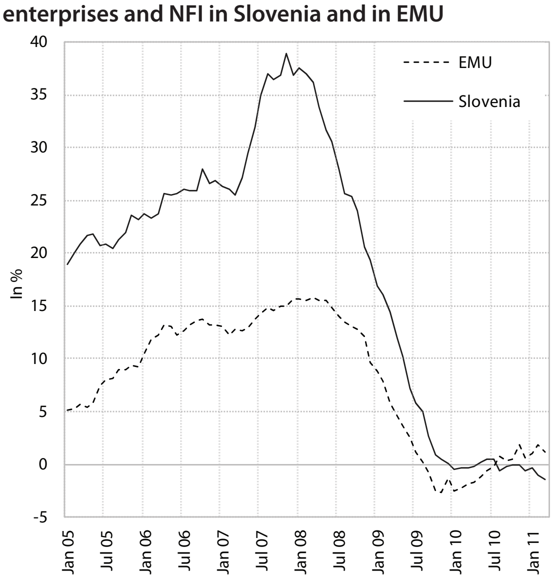
to enterprises based on the guarantee scheme was intended only to refinance already existing liabilities and slow down the deterioration of the quality of bank investments in Slovenia. The year 2010 saw the adoption of guarantees intended exclusively for investment loans yet no particular interest in such was observed, which might be due to the fact that banks probably require their clients pay risk premiums, which further increases the already high interest rates.

1.2.1. Corporate and NFI borrowing

After a modest yet positive net flow of domestic and foreign bank loans to enterprises and NFI in 2009, 2010 was characterised by the net repayment of loans by enterprises. Total net repayments nearly equalled EUR 400 m. In the first half of the year, enterprises and NFI repaid loans taken in foreign banks and in the second half of the year those taken in domestic banks. The volume of loans to enterprises and NFI in domestic banks last year recorded a 0.5% decrease and net repayment totalled EUR 125.2 m.[7] At first glance, this might not seem a significant drop, but Slovenian companies heavily depend on bank financing because of the poorly developed capital market. The reasons for the above decrease could thus include a more modest offer of loans by the banks and, as estimated, lower demand by enterprises as a result of the relatively low economic activity.

Practically all net repayment was attributable to NFI whereas corporate borrowing from domestic banks also remained positive in 2010. Net corporate borrowing totalled EUR 14.2 m, which is nearly 95% less than in 2009. NFI repaid loans taken in domestic banks in the amount of nearly EUR 140 m, which is over a quarter less than the year before.

Figure 4: **Year-on-year growth rates of bank loans to enterprises and NFI in Slovenia and in EMU**



Source: ECB, BS; calculations by IMAD.

[7] In 2009, the net flow was still positive and equalled EUR 23.6 m.

Enterprises and NFI nevertheless steadily repaid loans taken abroad. Total net repayment amounted to EUR 271.8 m. They mostly repaid short-term loans while net outflow of long-term loans was only EUR 13.2 m. Enterprises and NFI repaid net loans of foreign banks particularly in the first half of 2010, while in the second half of the year net repayment slowed down considerably and reached merely EUR 26.0 m.

1.2.2. Household borrowing

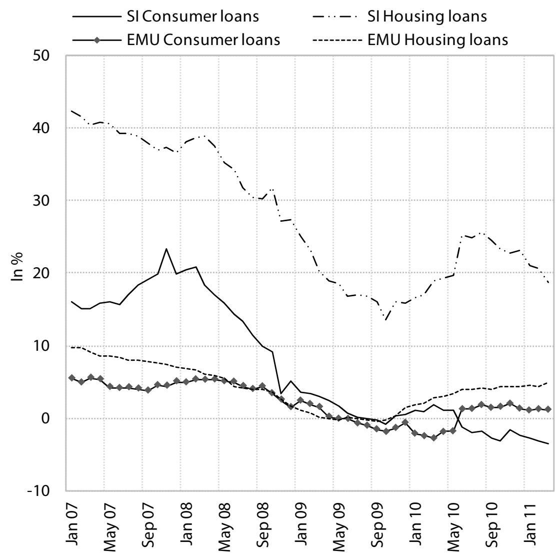
Owing to the boost in housing loans, the growth of household borrowing in 2010 was slightly above that in 2009. The value of housing loans rose by 23.2% and the same trend was followed in real-estate transactions with a 38.8% increase in registered purchases.[8] Last year thus saw the highest net flows of housing loans since 2005 (the first year when data were available). By the end of March 2011, the year-on-year growth of the volume of housing loans was similar to last year's (18.7%) although net flows amounted to just above EUR 40 m, which was only a quarter of the value recorded in the same period last year. According to the first estimates, also the number of real-estate transactions was lower (down by 27.3%).

The share of housing loans in total loans exceeded 50%. Since housing loans had been rising most rapidly over the past years and the growth of consumer loans had been slowing down, their volume increased considerably in a relatively short period of time and accounted for 52.1% at the end of 2010 (end of 2004: 23.3%). This is, however, still far below the share recorded in the EMU (end of 2010: 71.7%). In the last months of 2010 and first months of 2011, the volume of housing loans in Slovenia rose at a year-on-year rate of over 20%, in the EU at 8%, and in the EMU just above 4%. Contrary to Slovenia, the EMU has also been recording a slight increase in consumer loans since mid 2010 (see Figure 5).

Demand for consumer loans has been decreasing for the fourth consecutive year. After a modest rise in 2009, the volume of consumer loans in 2010 went down by 2.3%, as household consumption of durable

[8] Report on Average Real Estate Prices on the Slovenian Market for the First Quarter of 2011. Quarterly. (May 2011). Ljubljana: Surveying and Mapping Authority of the Republic of Slovenia.

Figure 5: **Year-on-year growth rates of loans to households in Slovenia and in the EU**



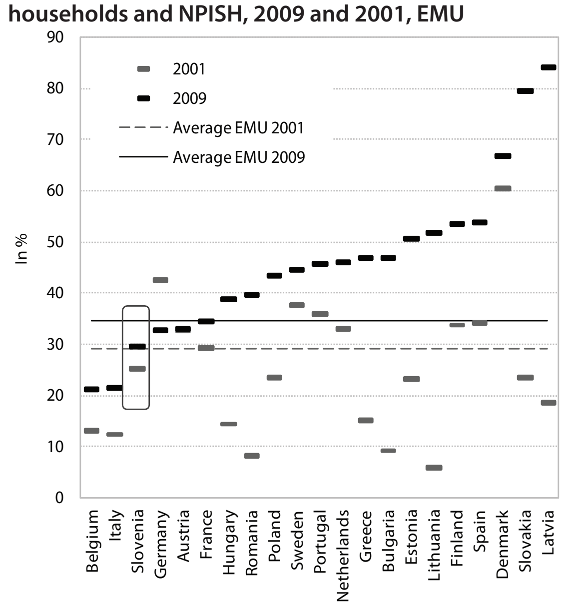
Source: ECB, calculations by IMAD.

goods – for which consumer loans are normally intended – dropped for the second year in the row. Last year saw the first net repayment of such loans in the amount of nearly EUR 70 m, and households have already repaid EUR 30 m in the first three months of 2011. Moreover, the downward trend in consumption on larger purchases continues; in the first three months of 2011 sales revenues in retail trade in furniture, household equipment, construction material, and audio and video equipment in specialised stores went down by 7.5%.

Considering the persistent uncertainty on foreign exchange markets, the interest in foreign currency loans is decreasing. The share of foreign currency loans has been falling since 2009.[9] In 2010, their net flows accounted for only 3% of all loans (EUR 28 m), whereas in 2008 they accounted for over 40% (EUR 413 m) and were repaid in 2009 on the onset of the financial crisis in the amount of EUR 175 m. In the first quarter of 2011, such loans were being repaid again (in the amount of over EUR 90 m). At the end of March, the share of foreign loans to households equalled 13.1% of total loans, which is 5.4 p.p. less than at the end of 2008 (when the highest values were recorded).

In aggregate terms, household indebtedness rose in 2010 but still remains low. In 2009, indebtedness slightly decreased both in Slovenia and on average in the EU countries for which data are available; it rose again in Slovenia in 2010. According to quarterly financial accounts, household liabilities (6.4%) again grew slightly more than financial assets[10] (5.0 %) owing to long-term loans (8.7%) because the volume of short-term loans went down for the first time by 5.5% (data available since 2004). Compared to 2009, indebtedness measured as the ratio between liabilities and financial assets rose by 0.4 p.p. to 30.0% and relative to GDP by 1.5 p.p. to 34.8%.

Figure 6: **Share of liabilities in financial assets, in %, households and NPISH, 2009 and 2001, EMU**



Source: EUROSTAT – Financial Accounts.
Note: the figure refers to EMU countries for which data are available (i.e. Cyprus, Malta, Luxembourg and Ireland excluded). The figure shows the weighted average of such countries.

1.3. Interest rates

Active interest rates for Slovenian enterprises are still relatively high. Slovenia narrowed the gap behind the euro area average but this was mainly due to a gradual increase of interest rates in the euro area and less to the decrease of domestic interest rates, which nevertheless remain among the highest in the euro area. At the end of the first quarter, interest rates for loans to enterprises exceeding EUR 1 m with a variable or up to one-year fixed interest rate were higher in Cyprus and Greece.[11] Interest rates in Slovenia differ from the EMU average even by more than 230 basis points. As a result of increasing inflationary pressures, at the beginning of the second

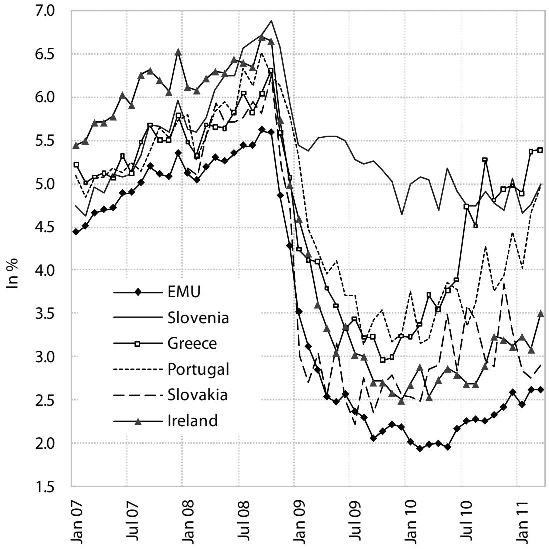
[9] The prevailing foreign currency is still the Swiss franc.

[10] Currency and deposits, securities, equity, insurance technical reserves, loans, other.

[11] Greece recorded the highest rise in interest rates in 2010, most probably as a result of the deterioration of the overall situation in the country.

quarter of the year the ECB was the first major central bank to have raised interest rates. It is estimated that most loans to enterprises and NFI have a variable interest rate,[12] meaning that a rise in interest rates could cause additional pressures to already heavily indebted enterprises.

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

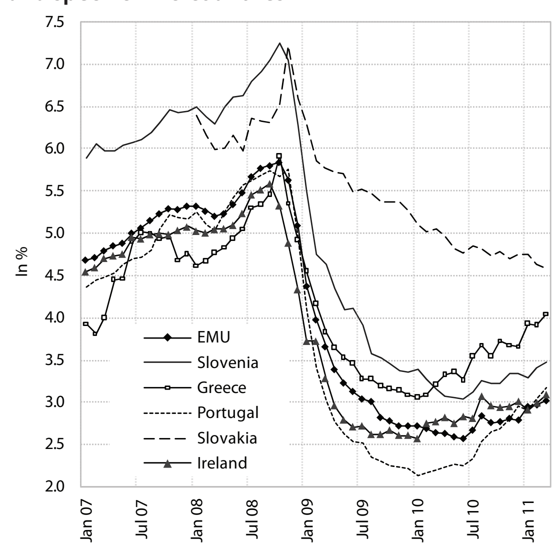


Source: BS, ECB.

According to the banks, the main reasons for higher interest rates are more expensive sources[13] and heavy indebtedness of Slovenian enterprises. No data allowing a direct comparison of borrowing terms in comparable banks of the euro area are available. Other data that can be related thereto indicate that countries with a higher country risk than Slovenia and with a relatively low capitalised banking system (e.g. Portugal, Ireland) have lower interest rates for corporate loans than Slovenia. It can therefore be estimated that margins in Slovenia are much higher than in the above members of the euro area. This is partly attributable to the fact that Slovenian enterprises are heavily indebted, since the volume of bank loans at the end of 2010 accounted for as much as 98.6% of the capital, which is one of the highest shares in the euro area, and simultaneously record the highest share of other liabilities, all reducing the financial impetus for enterprises and hindering their loan accessibility.

Considerably less accentuated are the differences in the interest rates for household loans, particularly housing loans, which have been keeping the lowest level ever since the introduction of the euro. This seems to derive from the fact that banks encourage such borrowing, thus transferring part of the risks from over-indebted construction sectors to the less risky households. Most loans are based on a variable interest rate, meaning that the expected rise in interest rates will also increase the burden of households linked to the repayment of loans if their income does not follow the upward trend of instalments.

Figure 8: **Interest rates for housing loans in Slovenia and specific EMU countries**



Source: BS, ECB.

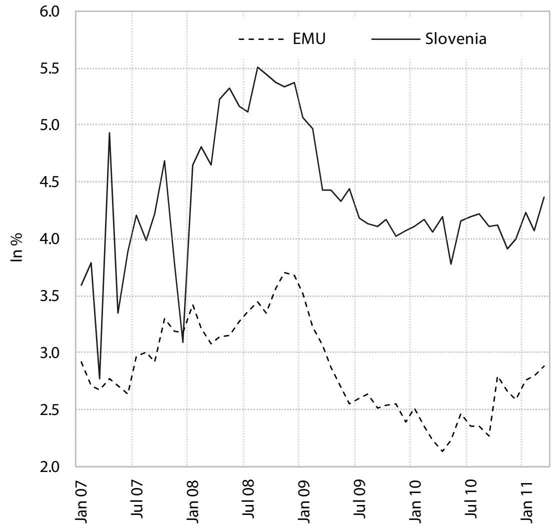
In contrast, banks are maintaining higher interest rates for long-term deposits.[14] This results from lower accessibility to long-term financial sources at international financial markets, while the banks try to make up for a part of the loss of foreign sources with domestic long-term sources, which are more stable than foreign ones. Therefore, interest rates for such deposits are still much higher than the euro area average. The banks pay particular attention to deposits with maturities of over two years, where the differences are the most accentuated and no reduction was recorded in the first quarter of 2011. However, Slovenian banks offer lower interest rates for short-term loans whereby they additionally encourage the transfer of short-term deposits among long-term deposits.

[12] The most common is EURIBOR. In 2011 alone (May), the value of Euribor rates of different maturities on average rose by almost 50 basis points. Although interbank interest rates were still far below the pre-crisis level, the burden of interest rates for enterprises did not decrease significantly as their results were below the 2007 and 2008 levels.

[13] Also a result of the unfavourable ratio between loans and deposits.

[14] Yet the differences in the amount of around 150 basis points are almost one third lower than in active interest rates for enterprises and NFI.

Figure 9: **Interest rates for deposits with maturities above two years in Slovenia and in EMU**



Source: BS, ECB.

2. Indebtedness and financial structure of Slovenian enterprises

The total assets and the financial structure of Slovenian enterprises were strongly affected by the poor development of the financial system. Compared with other members of the euro area, enterprises in Slovenia largely relied on loans that grew at an above-average rate during the period of favourable economic trends. This manner of financing was severely hit by the onset of the financial crisis, resulting in a reduced offer of loans as well as in a reverse cash flow from enterprises to banks. Enterprises thus found themselves under heavy liquidity pressures, which additionally inhibited the growth of their business operations.

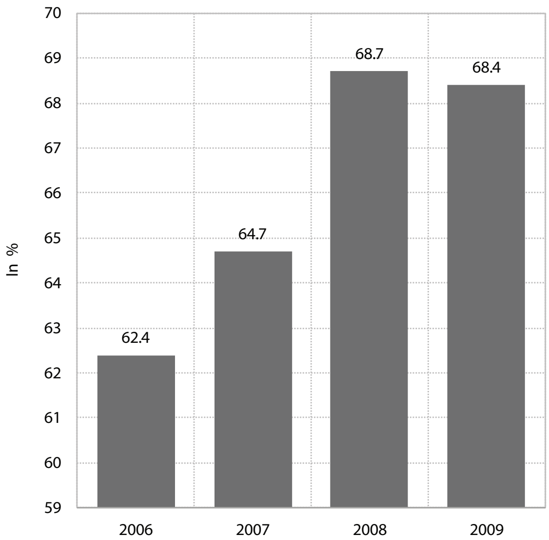
2.1. Corporate borrowing[15]

The analysis shows that the share of debt to total assets of enterprises*[16] *in the period 2006–2009*[17] *constantly grew (see Figure 10). In the crisis year of 2009, that share stayed at the same level as the year before. The analysis of private sector borrowing tried to establish whether indebtedness differs depending on the size of the enterprise, its export-orientation, and branch of business.

To finance their activities, enterprises resort to both bank loans and trade credits. The latter represents an additional source of financing and was quite stable throughout the 2006–2009 period (around 11%),

[15] This section focuses on corporate borrowing within the Slovenian business sector. Borrowing was analysed based on corporate data provided by the Agency of the Republic of Slovenia for Public Legal Records and Related Services (hereinafter: AJPES; balance sheets and income statements) for the period between 2006 and 2009. This database comprises data on every company in Slovenia. The analysis excluded extreme values where growth of financial liabilities of enterprises towards banks (Bank loans = Long-term bank loans (aop78) + Short-term bank loans (aop89)) was above 50,000% as such enterprises could distort the picture of the actual state of affairs as regards loans to Slovenian enterprises. The final sample covers 20,590 enterprises with an average four-year time horizon (i.e. 61,770 units), which between 2006 and 2009 accounted for 72% of the bank loans of all enterprises included in the database.
[16] The share of debt in total assets = (Reservations and long-term accruals (aop72) + Long-term liabilities (aop75) + Short-term liabilities (aop85) + Short-term accruals (aop95)) / total assets (aop55)
[17] This time frame was chosen because in 2006 the methodology was subject to a change, which above all reduced the value of capital at the level of all enterprises (see Kmet Zupančič et al.).

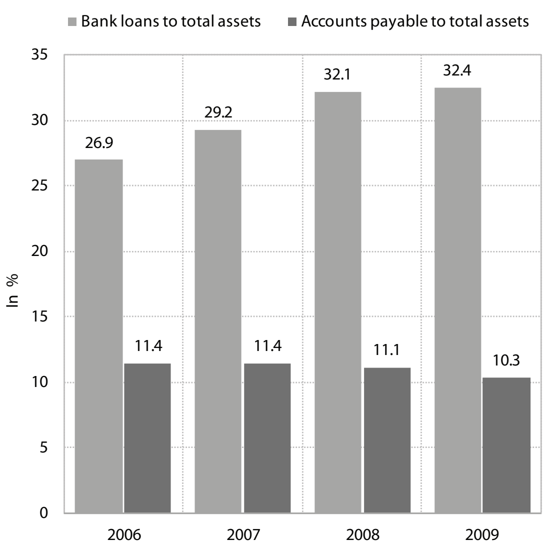
Figure 10: **Share of debt in the total assets of enterprises in the private sector, 2006–2009**



Source: AJPES, calculations by IMAD.

except in 2009 when it fell slightly (by 0.8 p.p.) also as a consequence of the significant decrease of the volume of business. The share of bank loans in the total assets of enterprises[18] constantly grew until 2009, when it remained at the level of 2008 (around 32%).

Figure 11: **Share of bank loans and accounts payable in the total assets of enterprises[19] in the private sector, 2006–2009**



Source: AJPES, calculations by IMAD.

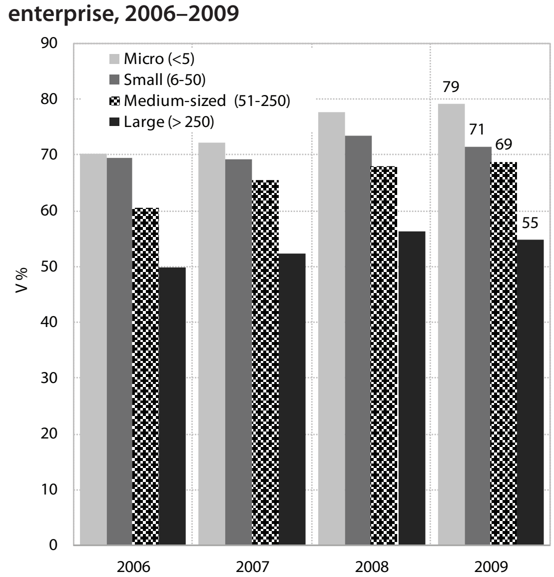
[18] Share of bank loans in the total assets of enterprises = (Long-term bank loans (aop78) + Short-term bank loans (aop89)) / total assets (aop55).

[19] Share of accounts payable in the total assets of enterprises = (Long-term accounts payable (aop82) + Short-term accounts payable (aop93)) / total assets (aop55).

2.1.1. Corporate borrowing by size of enterprise[20]

As regards the size of the enterprise, in 2006–2009 the largest share of debt was recorded by micro-enterprises while the smallest share was seen in large enterprises (see Figure 12). In 2009, the share of debt in the total assets of micro-enterprises was 79%, of small enterprises 71%, medium-sized enterprises 69%, and large enterprises 55%. Although the share of debt in the total assets of enterprises in the private sector stayed at the 2008 level, its growth dynamics differed depending on the size of the enterprise. It rose by 1.5 p.p. in micro-enterprises and by 0.8 p.p. in medium-sized enterprises. In contrast, small and large enterprises reduced their debts by 1.9 p.p. and 1.5 p.p., respectively.

Figure 12: **Share of debt in the total assets by size of enterprise, 2006–2009**



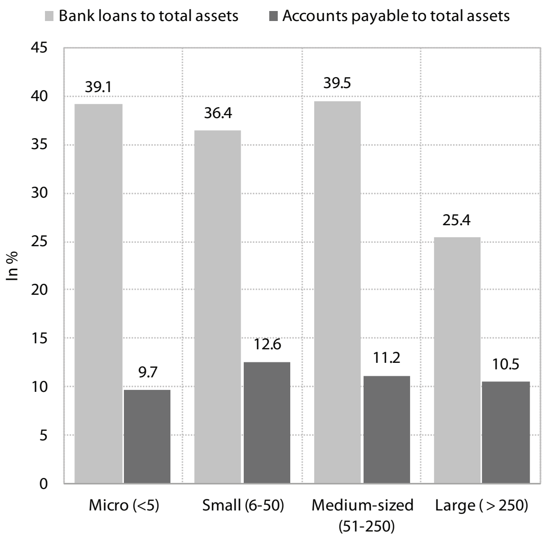
Source: AJPES, calculations by IMAD.

The structure of debt in the total assets of enterprises is rather similar in all size categories.[21] Bank loans prevail, mostly in medium-sized, micro- and small enterprises (on average around 38%). The latter are also slightly more inclined towards trade credits (around 13%). In 2009, such type of borrowing decreased in all classes, except in micro-enterprises where accounts payable grew by 21%.

[20] Below are the results of the analysis of corporate borrowing by size of enterprise, whereby micro-enterprises employ up to 5 employees, small enterprises 6–50 employees, medium-sized enterprises 51–250 employees, and large enterprises above 250 employees. The entire database includes 56% micro-enterprises, 36% small enterprises, 6% medium-sized enterprises and 2% large enterprises.

[21] Some major discrepancies were observed only in the category of large enterprises.

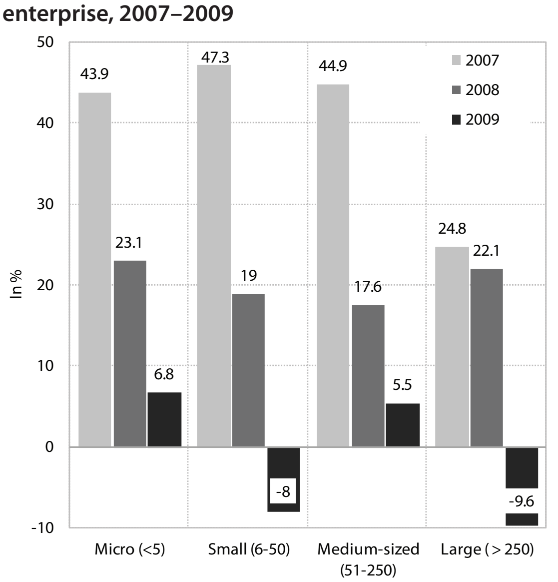
Figure 13: **Share of bank loans and accounts payable in the total assets of enterprises, by size of enterprise, 2009**



Source: AJPES, calculations by IMAD.

A glance at the growth of bank loans (see Figure 14) reveals that growth slowed down parallel to the deepening of the financial crisis. In 2009 it fell by around 16 p.p. in micro-enterprises and by around 12 p.p. in medium-sized enterprises, whereas small and large enterprises even recorded a decrease in bank loans, by 8% and around 10%, respectively. One of the reasons for such a downturn might be that the above enterprises experienced a more explicit reduction in the volume of sales revenues[22] than micro and

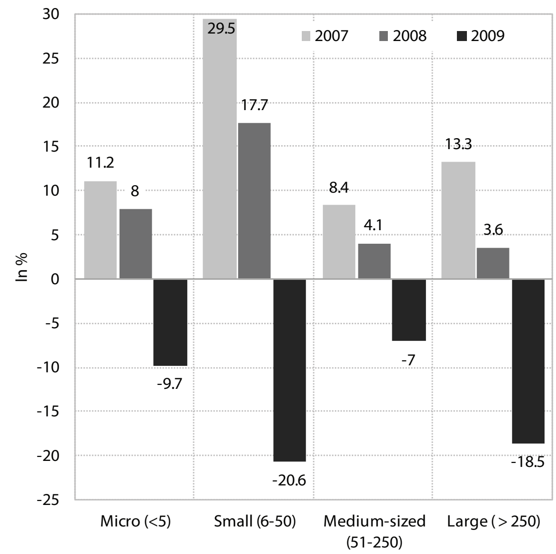
Figure 14: **Growth of bank loans of enterprises by size of enterprise, 2007–2009**



Source: AJPES, calculations by IMAD.

[22] Sales revenues (aop110).

Figure 15: **Growth of sales revenues by size of enterprise, 2007–2009**

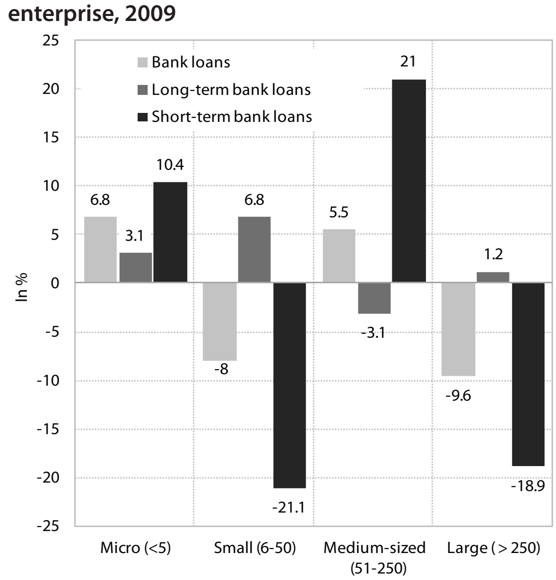


Source: AJPES, calculations by IMAD.

medium-sized enterprises. The credit potential of such enterprises thus also decreased more significantly, which affected the extent of their indebtedness. Although – as seen in Figure 15 – micro and medium-sized enterprises also recorded a reduction of sales revenues, which was almost half lower than in small and large enterprises (small enterprises: -20.6%, large enterprises: -18.5%).

Although the sources of bank financing were limited, the maturity dynamics of bank loans changed (see also p. 39). Enterprises reduced the

Figure 16: **Maturity of financial liabilities by size of enterprise, 2009**



Source: AJPES, calculations by IMAD.

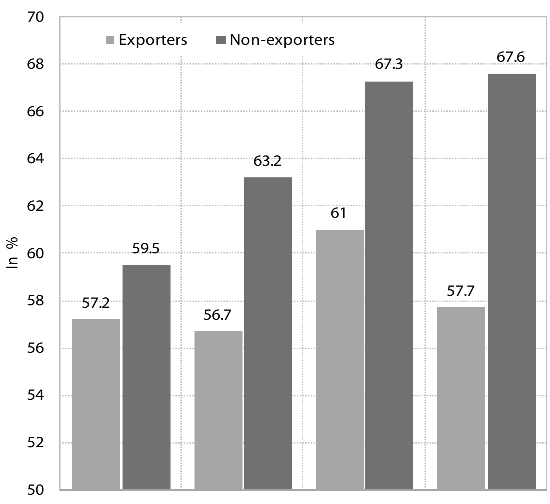
volume of short-term bank loans[23] and continued to increase the volume of long-term bank loans[24] (see Figure 16). In 2009, short-term bank loans of small enterprises fell by 21% while long-term bank loans still recorded 7% growth. In large enterprises, short-term bank loans were down by almost 19% while long-term bank loans increased by 1.2%. Short-term loans were taken only by micro and medium-sized enterprises.

2.1.2. Borrowing by export-orientation[25]

The analysis of borrowing based on export-orientation reveals that enterprises oriented on the domestic market are more indebted than export-oriented enterprises. In 2009, the share of debt of non-exporters was 68% while the debt of exporters was 58%. Over the 2006–2009 period, the share of debt in the total assets of non-exporters constantly increased whereas the share of exporters in 2007 and 2009 fell. (See Figure 17).

Bank loans represent an important source of financing to both exporting and non-exporting enterprises (see Figure 18). Bank loans constantly grew between 2006 and 2008, while in 2009 they

Figure 17: **Share of debt in total assets by export orientation, 2006-2009**

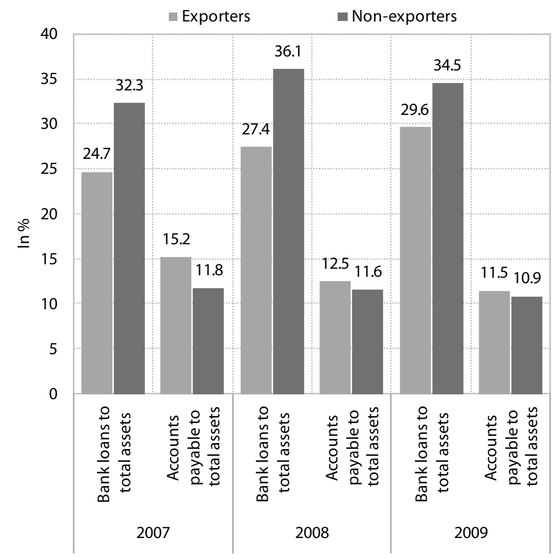


Source: AJPES, calculations by IMAD.

further increased among exporters (by 2.2 p.p. to 29.6%) and fell among non-exporters (by 1.6 p.p. to 34.5%). Accounts payable were higher among export-oriented enterprises than among enterprises oriented to the domestic market. The relevant trend was rather stable throughout the entire period, keeping at around 14% among exporters and around 12% among non-exporters; in 2009, such shares decreased by 1.0 p.p. and 0.7 p.p., respectively.

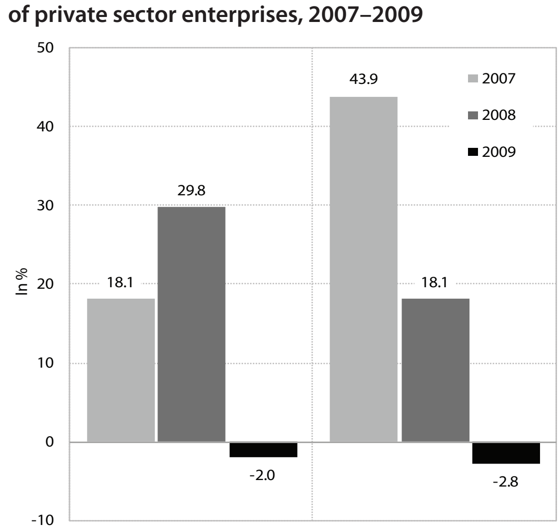
Bank loans to exporters and non-exporters have recorded fairly uneven growth movements after 2007. In 2008, they continued to grow among the

Figure 18: **Share of bank loans and accounts payable in the total assets of enterprises, 2007–2009**



Source: AJPES, calculations by IMAD.

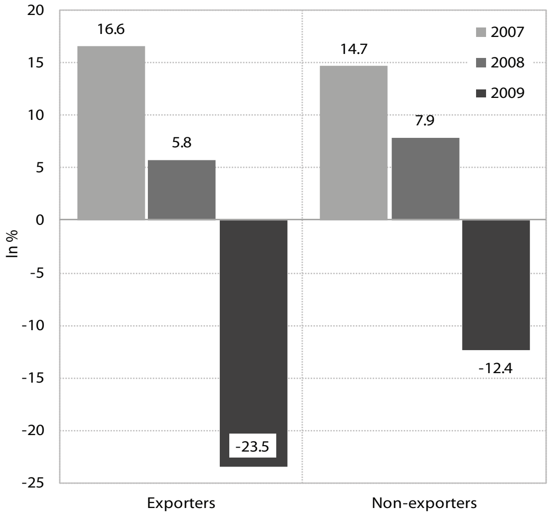
Figure 19: **Growth of bank loans by export-orientation of private sector enterprises, 2007–2009**



Source: AJPES, calculations by IMAD.

[23] Short-term bank loans (aop89).
[24] Long-term bank loans (aop78).
[25] Export-oriented enterprises are enterprises whose sales revenues on foreign markets (Sales revenues on foreign markets = Sales revenues on EU market (aop115) + Sales revenues on non-EU markets (aop118)) exceed sales revenues on domestic markets. The database comprises 10% export-oriented enterprises and 90% domestic market-oriented enterprises; the latter account for 68.7% of value added of all enterprises in the database.

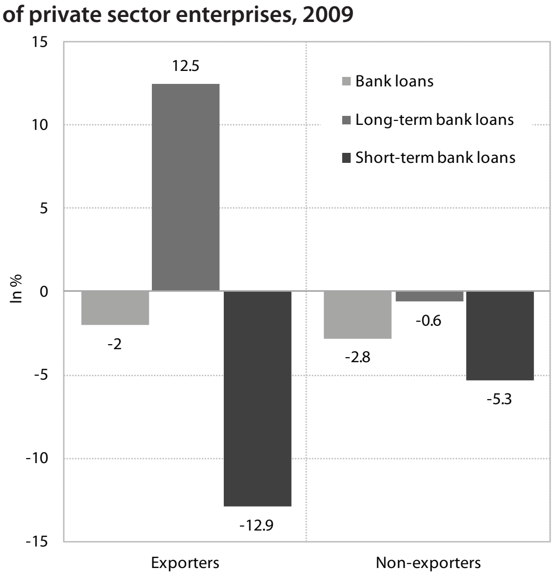
Figure 20: **Growth of sales revenues by export-orientation of private sector enterprises, 2007–2009**



Source: AJPES, calculations by IMAD.

exporters but slowed down considerably among non-exporting companies, while in 2009 both groups reduced the volume of bank loans. Exporters were more severely affected by the 2009 economic crisis. This was also reflected in the dynamics of cash flows of exporters and non-exporters (see Figure 20). The decline in sales revenues among export-oriented enterprises in 2009 alone exceeded the growth of sales revenue in non-exporters by around 11 p.p., but nevertheless the volume of bank loans decreased slightly less among exporters than among enterprises oriented on the domestic market, which might be due to the lower indebtedness of Slovenian exporters.

Figure 21: **Maturity of liabilities by export-orientation of private sector enterprises, 2009**



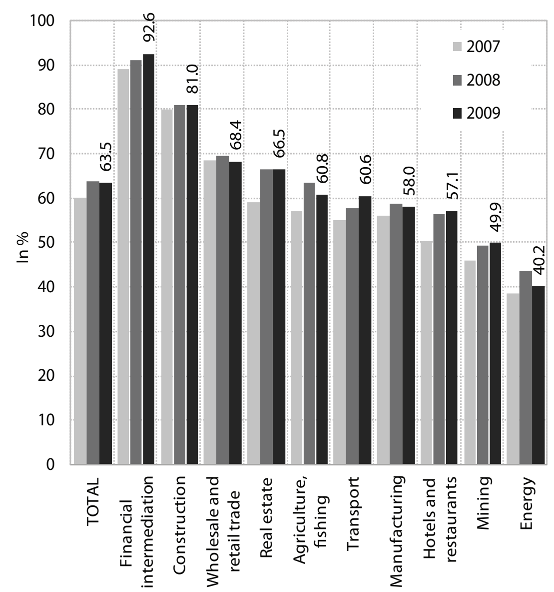
Source: AJPES, calculations by IMAD.

The borrowing dynamics by maturity changed more evidently among export-oriented enterprises. In times of positive economic prospects (2006-2007), they recorded a higher growth of short-term bank loans. However, in 2008, with the deterioration of the economic situation, the ratio began to change and, in 2009, eventually turned to the benefit of long-term borrowing that recorded a 12.5% growth while short-term borrowing went down by 12.9%. Enterprises operating in the domestic market recorded different dynamics of loan maturity. With the exception of 2007, long-term borrowing was preferred, which in 2009 fell by 0.6%, while the volume of short-term bank loans decreased by 5.3%.

2.1.3. Borrowing by activities[26]

The analysis of business sector borrowing by activities reveals that in the 2007–2009 period the most heavily indebted were enterprises operating in financial intermediation[27] (almost 93%), construction (81%) and wholesale and retail trade (around 68%) (see Figure 22). In addition to manufacturing, where borrowing accounts for 58%, the above activities also record the largest

Figure 22: **Share of debt in the total assets by activities, 2007–2009 (considering the situation in 2009)**



Source: AJPES, calculations by IMAD.

[26] In order to ensure greater consistency of the sample, data are classified according to the 2002 Standard Classification of Activities (SCA).

[27] Data regarding financial intermediation are extremely modest since the database contains no information on banks or insurance companies, which are the main players in this activity.

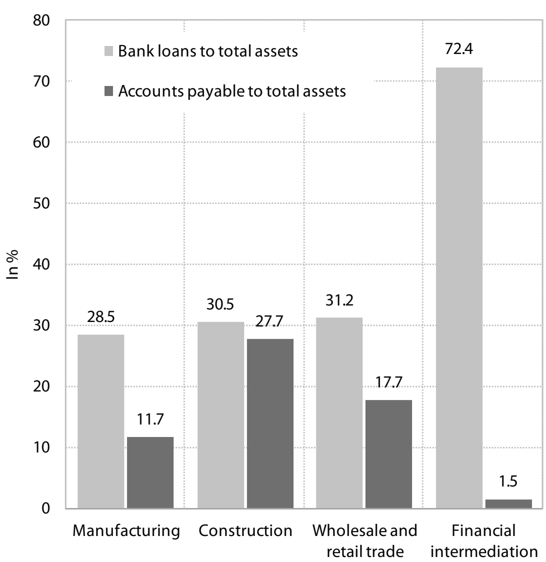
Table 1: **Share of bank loans and accounts payable in the total assets of enterprises, 2007-2009, in %**

	2007		2008		2009	
	Bank loans to total assets	Accounts payable to total assets	Bank loans to total assets	Accounts payable to total assets	Bank loans to total assets	Accounts payable to total assets
Agriculture, fishing	26.2	11.2	31.3	11.5	31.3	10.6
Mining	17.8	6.8	21.0	7.8	23.7	7.0
Manufacturing	24.9	14.8	28.0	13.2	28.5	11.7
Energy	10.2	6.8	12.4	7.5	12.6	7.2
Construction	27.1	30.8	28.3	29.9	30.5	27.7
Wholesale and retail trade	30.2	20.1	32.9	19.0	31.2	17.7
Hotels and restaurants	27.5	6.6	31.5	5.6	33.1	5.2
Transport	21.7	8.6	25.2	9.1	24.6	8.4
Financial intermediation	72.6	2.3	72.0	1.3	72.4	1.5
Real estate	33.9	6.4	38.7	5.6	35.9	6.1

Source: AJPES, calculations by IMAD.

share of non-performing claims[28] (see p. *112-114*). The analysis therefore focused on the above sectors. Manufacturing involves 22.6% of all enterprises, construction 9.4%, wholesale and retail trade 31.4% and financial intermediation 1.3%, while the remaining 35.3% of enterprises operate in other activities not subject to analysis in this section.

Figure 23: **Share of bank loans and accounts payable in the total assets of enterprises, 2009**



Source: AJPES, calculations by IMAD.

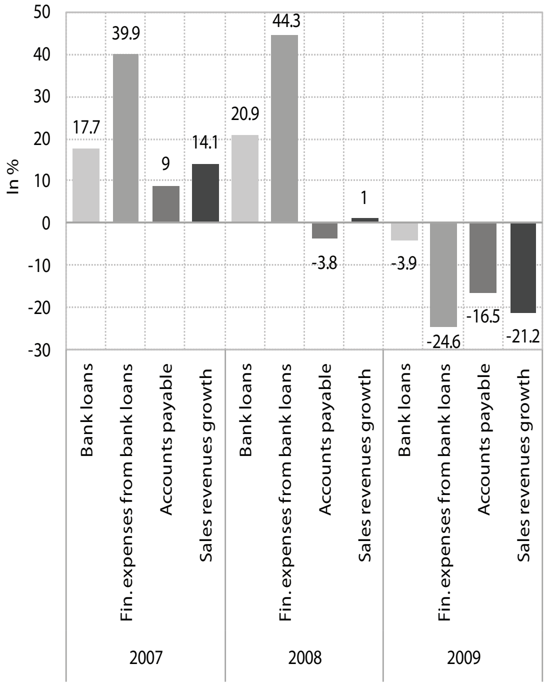
[28] Data are not fully comparable because the analysis of corporate borrowing in Slovenia uses data by activities according to the 2002 SCA, while the share of non-performing claims is classified according to the currently applicable 2008 SCA. Significant discrepancies are observed particularly in financial intermediation, which now includes holdings (taking up a major share of non-performing claims of the financial sector) while the previous classification placed them under real estate, renting and business activities.

In 2006–2008, the share of debt in the total assets grew in all the above activities and then decreased in 2009. In wholesale and retail trade, this share fell by 1.3 p.p., followed by manufacturing (-0.9 p.p.) and construction (-0.2 p.p.), while in financial intermediation debt continued to rise and was up by 1.5 p.p. Enterprises in manufacturing, wholesale and retail trade as well as financial intermediation mainly finance their operations with bank loans, while construction companies seem to prefer accounts payable (see Table 1). Bank loans in the total assets shrank considerably, not as a consequence of debt reduction but rather of the significant decrease of interest rates.

2.1.3.1. Manufacturing

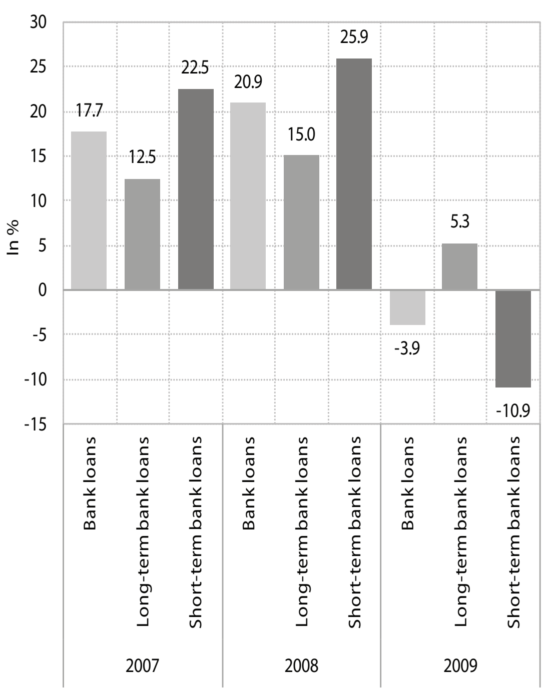
In manufacturing, the share of bank loans grew constantly throughout the entire period, reaching around 29% in 2009. Accounts payable were more than one half lower and ranged around 14% during the whole period, yet have been declining ever since the worsening of the crisis in 2008 (see Table 1). Bank loans, i.e. financial liabilities of manufacturing enterprises towards banks, further increased in 2008 but fell by nearly 4% in 2009 (see Figure 24). The crisis in fact mainly affected the exporting part of the economy, above all manufacturing, which is the most export-oriented activity. In 2008, growth of sales revenue slowed down and was only 1%. In 2009, manufacturing also saw a major decline in revenue compared with other activities (21%). The restricted cash flow of enterprises in manufacturing is, according to IMAD's estimates, one of the main reasons for reduced bank borrowing among these enterprises.

Figure 24: **Bank loans, financial expenses from bank loans, accounts payable, and sales revenues of enterprises in manufacturing**



Source: AJPES, calculations by IMAD.

Figure 25: **Maturity of bank loans of enterprises in manufacturing, 2007–2009**



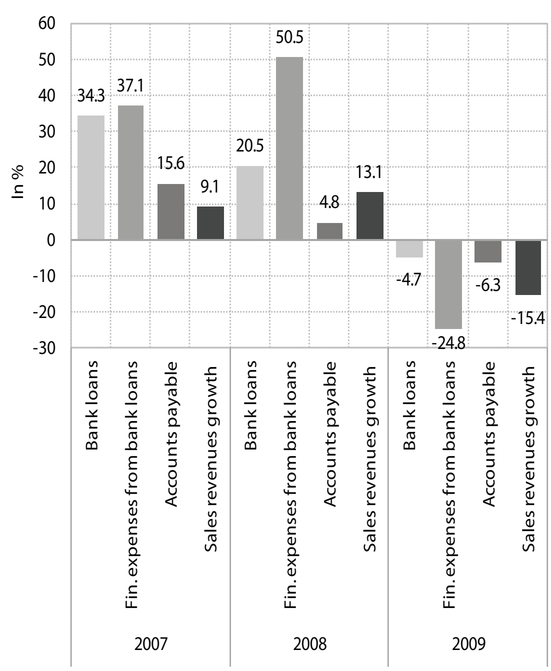
Source: AJPES, calculations by IMAD.

Like other activities, manufacturing was also subject to change as regards the maturity of loans. Typical of enterprises operating in manufacturing is higher growth of short-term borrowing, which might also be a consequence of the fact that enterprises in this sector mainly took up loans to finance their current operations.[29] This changed in 2009 when short-term borrowing decreased by 11%, also because of a lower volume of operations, while the growth of long-term borrowing also slowed down, but still accounted for 5%.

2.1.3.2. Wholesale and retail trade, motor vehicles repair

Compared to other activities, in 2009 the decrease of bank loans was mostly felt in wholesale and retail trade and the repair of motor vehicles (hereinafter: wholesale and retail trade). Figure 26 indicates that growth began to gradually slow down in 2008 despite a 13% increase of sales revenues. In 2009, sales revenues went down by 15% (much less than in other activities analysed herein). The share of bank loans grew in 2006–2008 but fell in 2009 by 1.7 p.p. to 31%. Throughout this period, accounts payable on average accounted for 19% and have been decreasing ever since the beginning of the crisis (see Table 1).

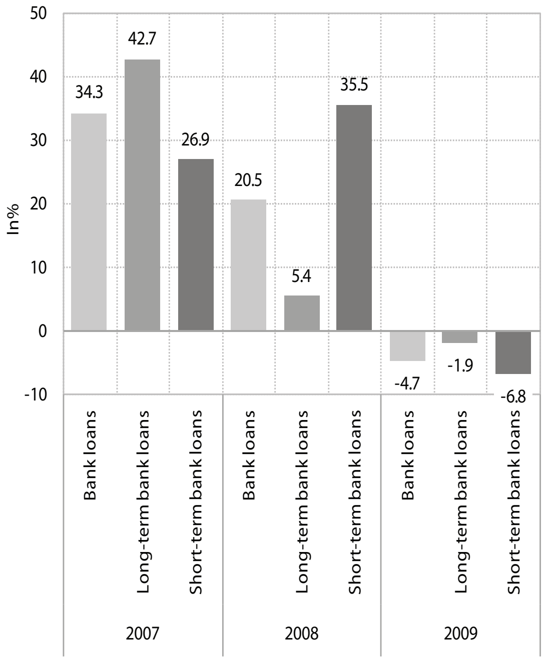
Figure 26: **Bank loans, financial expenses from bank loans, accounts payable, and sales revenues of enterprises in wholesale and retail trade**



Source: AJPES, calculations by IMAD.

[29] The share of short-term bank loans in manufacturing was above average.

Figure 27: **Maturity of bank loans of enterprises in wholesale and retail trade, 2007–2009**



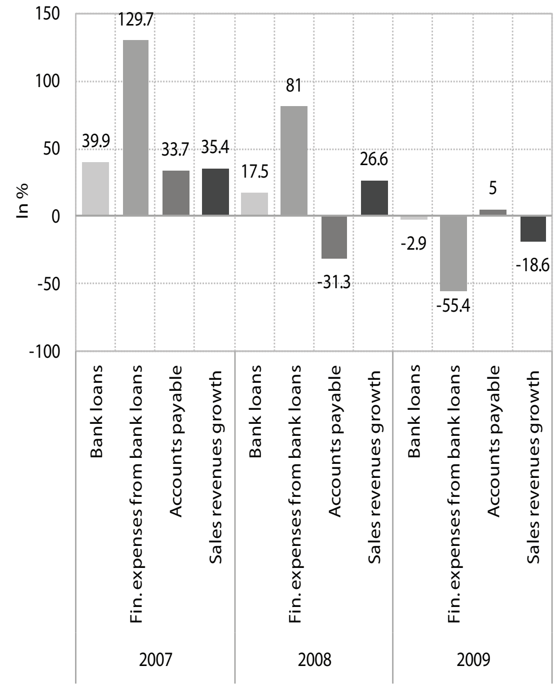
Source: AJPES, calculations by IMAD.

Looking at the maturity of loans (Figure 27), the crisis certainly also affected wholesale and retail trade, although maturity shows a different pattern than in other activities. Until 2007, enterprises in wholesale and retail trade took up long-term loans, while in 2008, they leaned more towards short-term borrowing. In 2009, both long-term and short-term borrowing declined.

2.1.3.3. Financial intermediation

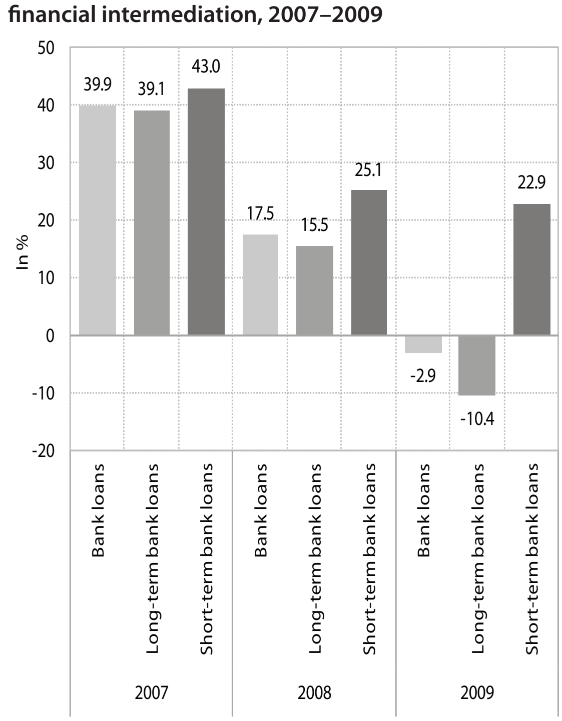
Compared to other activities, financial intermediation recorded the largest share of bank loans. This share grew in 2006–2007 and stayed at 72%. Borrowing from suppliers was rather insignificant, accounting for around 2% throughout the entire period (see Table 1). After 2007, enterprises providing financial intermediation considerably lowered bank borrowing (see Figure 28). In 2009, bank loans dropped by almost 3%, which was probably attributable to the lower cash flow of these enterprises (19%). In contrast to other sectors, the volume of short-term bank loans in 2009 grew while long-term bank loans shrank (see Figure 29).

Figure 28: **Bank loans, financial expenses from bank loans, accounts payable, and sales revenues of enterprises in financial intermediation**



Source: AJPES, calculations by IMAD.

Figure 29: **Maturity of bank loans of enterprises in financial intermediation, 2007–2009**



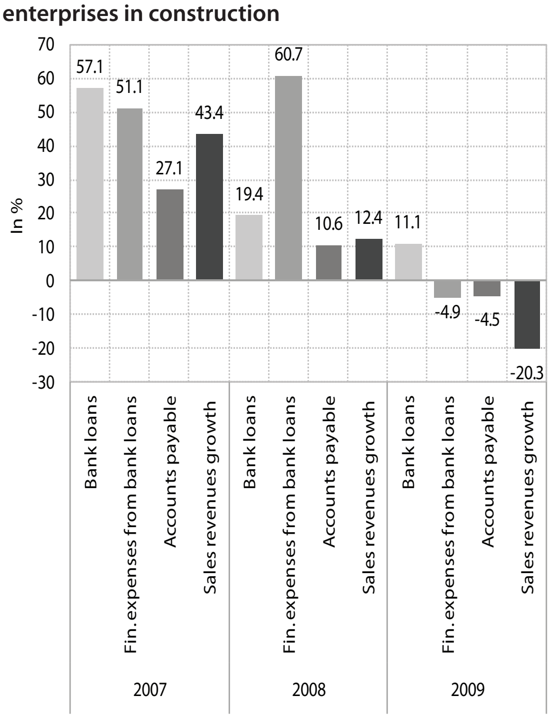
Source: AJPES, calculations by IMAD.

2.1.3.4. Construction

Unlike enterprises in financial intermediation and far above other activities, construction companies heavily rely on credit from suppliers.[30] Throughout the period under consideration, credit from suppliers accounted on average for 30% but declined in 2009 by 2.2 p.p. to 27.7%. The share of bank loans was around 25% and constantly rising, reaching nearly 31% in 2009. Thus, in 2009, bank loans became more important than accounts payable (see Table 1).

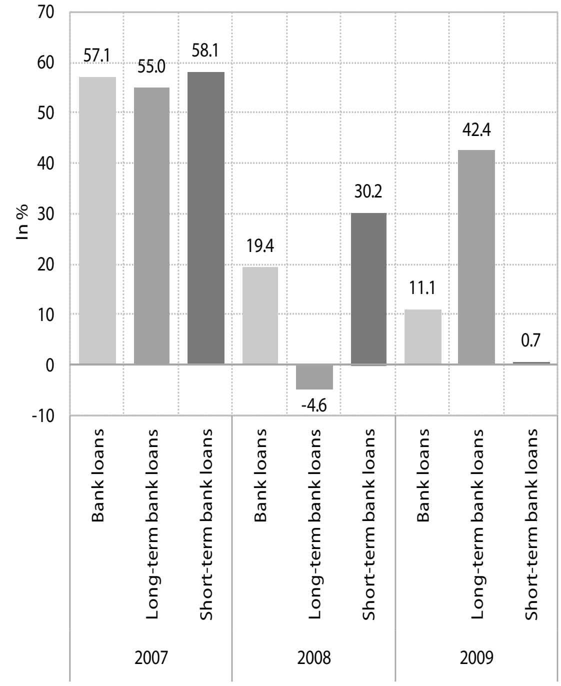
Construction, where enterprises operate predominantly on the domestic market, is one of the rare activities whose volume of bank loans in 2009 increased. Growth of such liabilities slowed down after 2007 but nevertheless exceeded 10% (see Figure 30). This is rather surprising, considering that sales revenues in this sector fell by more than a fifth. One of the possible reasons for the positive growth of bank loans is also the fact that enterprises oriented to the domestic market were hit by the crisis at a later stage and in 2008 still recorded a 12% growth of cash flow (unlike manufacturing, for example). In addition, the banks offered these companies the possibility of refinancing their loans, although their unfavourable business situation was becoming increasingly obvious. The year 2009 still saw a prevalence of long-term loans while short-term loans grew only slightly (see Figure 31).

Figure 30: **Bank loans, financial expenses from bank loans, accounts payable, and sales revenues of enterprises in construction**



Source: AJPES, calculations by IMAD.

Figure 31: **Bank loans maturity of enterprises in construction, 2007–2009**



Source: AJPES, calculations by IMAD.

2.1.4. Borrowing by activities in 2010

Although the amount of loans to enterprises and NFI decreased in 2010,[31] ***total exposure***[32] ***of the Slovenian banking system to domestic economic activities expanded.*** Considering the rapid loan growth in the past and the related heavy indebtedness of Slovenian enterprises, one would expect that total exposure – particularly in the most indebted activities – decreased. The data however show that particularly the most heavily indebted activities (whose liabilities towards banks at the end of 2010 exceeded the volume of their capital) showed no sign of reduced exposure; quite the contrary, in most cases, exposure rose. This applies in particular to financial intermediation[33] and

[30] The lack of payment discipline is a major issue in this sector.

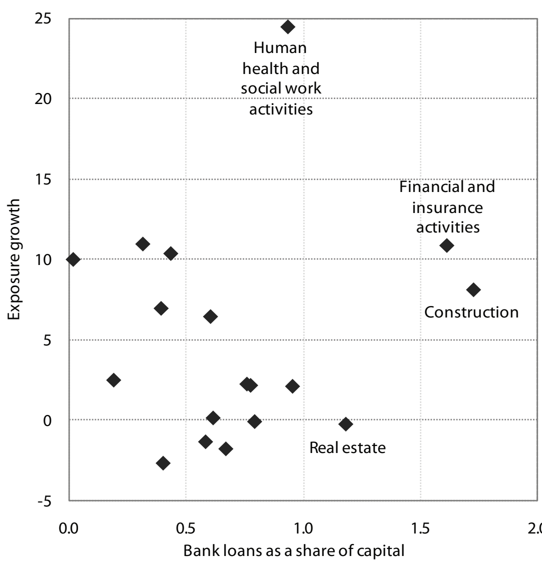
[31] Data on activities in 2010 are classified according to 2008 SCA and are not fully comparable with those used in the analysis on previous pages.

[32] In addition to bank loans, total exposure also comprises other bank claims towards enterprises measured by redemptory price. Moreover, this group includes off-balance sheet exposures such as guarantees.

[33] According to IMAD's estimates, growing exposure in financial intermediation is more a consequence of the slightly higher interbank lending and not as much of higher exposure to holdings, which are the most risky segment of financial intermediation.

construction, i.e. activities where no recovery was seen yet. The continuing exposure is, to IMAD's estimate, the consequence of the fact that banks mitigate the current problems of those sectors. Given the existing situation in the Slovenian banking system,[34] this does not seem to be sustainable and in the future the banks will probably have to reduce exposure, mainly to these sectors. The extent of total exposure of the Slovenian banking system thus increased by 3.7% or EUR 1.2 bn. Almost 70% of the entire growth results from increasing exposure to financial intermediation. A considerable rise of exposure was also recorded in relation to construction, which was up by EUR 270 m (or 8.1%) compared to the year before. It is estimated that growth in such activities could also be due to high penalty interest rates[35] and more frequent delays.[36] In addition to the above, exposure also grew in the less risky public services.

Figure 32: **Share of bank loans and growth of exposure of the Slovenian financial system to individual economic activities**



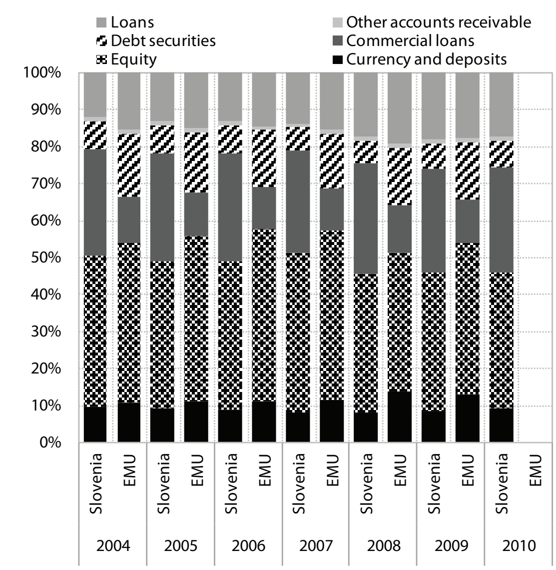
Source: BS, AJPES, calculations by IMAD.

In contrast, the banks reduced exposure to other activities. In terms of value added, the most important among them is manufacturing, although this sector presents differences between individual activities. Thus, exposure declined mostly in technologically demanding activities but grew in technologically less demanding branches. The extent of exposure also continued to fall in wholesale and retail trade and was by almost EUR 300 m lower than at the end of 2008 (see p. 102).

2.2. Financial structure of enterprises

Slovenian enterprises and NFI have a relatively low volume of financial assets[37] compared with liabilities, and are therefore more dependent on external financing. The share of financial assets compared to liabilities of Slovenian enterprises and NFI is less than 60%, whereas in the EMU it is almost 80%. Slovenia records a large share of other accounts receivable, which is almost 30%, twice as high as the EMU average. In this segment of financial liabilities, the largest share is held by trade credits, meaning that Slovenian enterprises and NFI have claims on buyers that exceed the average and represent – given the relatively strong lack of payment discipline – rather illiquid assets. Conversely, there is a modest share of more liquid financial assets such as currency and deposits as well as securities other than shares which together account for just above 15% of all financial assets of enterprises and NFI, which is more than a half less than the euro area average. At the same time, Slovenian enterprises and NFI record an above-average share of short-term financial liabilities and are thus more exposed to liquidity pressures.

Figure 33: **Structure of financial assets of enterprises and NFI in Slovenia and in the euro area, 2004–2010**



Source: BS, Eurostat, calculations by IMAD.

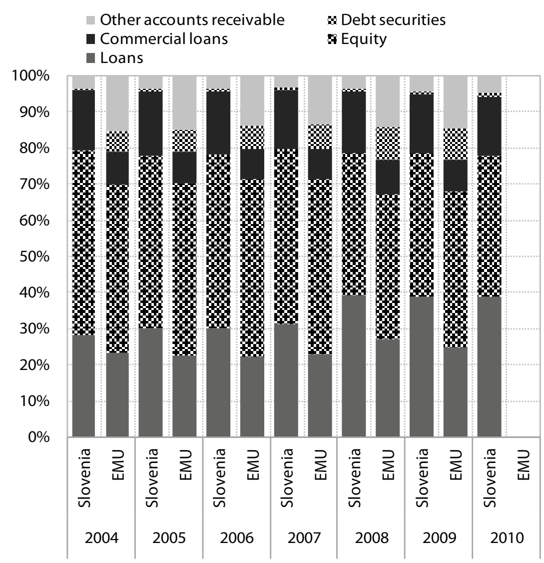
[34] Above all, the low capital adequacy of Slovenian banks and further deterioration of the quality of bank assets, which additionally worsened in the first quarter of 2011.
[35] 2010: 9%.
[36] In construction, the share of assets of late payers with delays of over 90 days rose from 7.7% to 19.3%.

[37] See note 10.

2.2.1. Structure of total assets

The structure of total assets of Slovenian enterprises and NFI differs considerably from the average structure in the euro area. The main difference is the great share of loans in the total assets, which in 2010 – given the modest net repayment – did not decrease noticeably. Other liabilities present differences as well, in particular trade credits and advances, which in the structure of financial liabilities account for nearly twice the average of the euro area and are the highest among all Member States. According to IMAD's estimates, in addition to the lack of payment discipline, such a large share is due to the poorly developed financial system, unable to sufficiently meet the financial needs of the economy. An above-average share of the said financial liabilities is observed in all new Member States that joined the euro area after 2002[38] and that have – measured by development indicators – an underdeveloped financial system (see e.g. Development Report 2011).

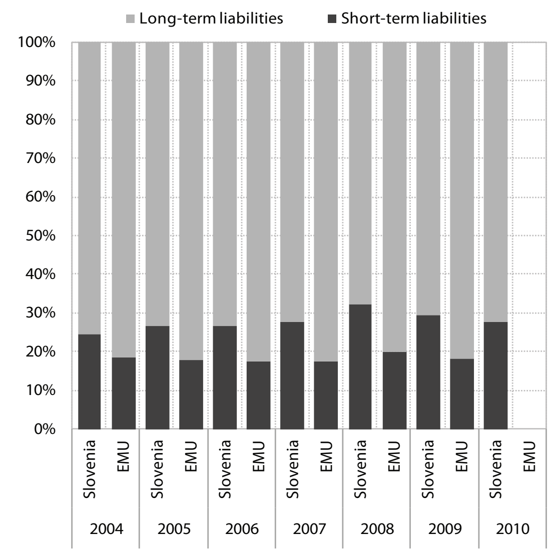
Figure 34: **Structure of financial liabilities of enterprises and NFI in Slovenia and in the euro area, 2004–2010**



Source: BS, Eurostat, calculations by IMAD.

After 2007, the share of equity capital[39] decreased both in Slovenia and in the rest of the euro area. This was mainly due to the significantly lower value of shares in practically all capital markets of the euro area. In Slovenia, such a decrease was even more evident owing to greater volatility and lower liquidity of the Slovenian capital market while the provision of new total assets through the issue of new shares was insignificant. However, in the structure of financial liabilities of enterprises and NFI, growth was recorded by loans and, to a slightly lesser extent, by other accounts receivable.[40] In the euro area, the share of debt securities rose on the account of a lower volume of equity capital while in Slovenia debt securities remained a rather unimportant source of financing of enterprises and NFI. It is estimated that this is due to the poor development of the capital market as well as the relative smallness of Slovenian enterprises, for which such a manner of financing is rarely economically justifiable.

Figure 35: **Maturity structure of corporate and NFI loans in Slovenia and in the euro area, 2004–2010**



Source: BS, Eurostat, calculations by IMAD.

The share of short-term liabilities[41] of Slovenian enterprises and NFI is almost two thirds higher than the euro area average, which further increases the possibility of liquidity problems in the Slovenian economy. In the previous two years, the volume of short-term financial liabilities shrank by almost 15% and their share was down by 4.5 p.p. This was a consequence of the restructuring of loan maturity, which also continued in 2010. In the period of the most intense lending activity (2007 and 2008), enterprises and NFI largely used short-term borrowing because of more favourable terms although they actually used such funds to finance long-term projects which – given their maturity and the expansion of the financial crisis also to the real sector – did not allow sufficient free cash flow for the enterprises and NFI to

[38] Also other new EU Member States (for which data are available) that have not yet introduced the euro record a large share of other accounts receivable among financial liabilities.

[39] Equity capital comprises shares as well as investment funds units and other equity capital.

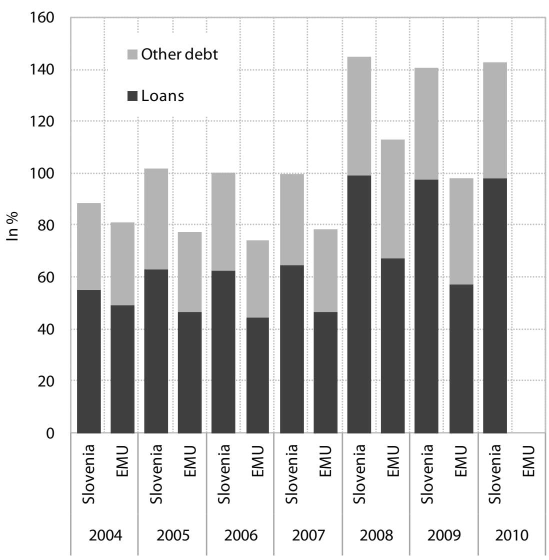
[40] Insurance technical reserves by insurance companies.

[41] Short-term liabilities comprise short-term loans, short-term securities and other accounts receivable of a short-term nature.

smoothly repay the liabilities due. It is estimated that in order to prevent an even faster deterioration of the quality of their assets, the banks allowed enterprises and NFI to restructure a part of their short-term loans into long-term loans.[42] Only in the previous two years did the volume of short-term loans fall by EUR 3.8 bn (by almost 25%), while long-term loans increased by EUR 3.5 bn (14%), thus mitigating the pressure on the liquidity of Slovenian enterprises and NFI.

Slovenian enterprises and NFI still rank among the most heavily indebted of the euro area. In 2009, the ratio between loans and equity capital did not decrease considerably; with 97.1%, it is among the highest in the euro area, where it shrank by almost 10 p.p. to 57.7%. Such a decrease is attributable to a reduced volume of corporate and NFI loans as well as being a consequence of the growing value of shares and supply of capital. Likewise, total indebtedness[43] in Slovenia in 2009 decreased less than in the euro area.

Figure 36: **Corporate and NFI debt relative to capital in Slovenia and in the euro area, 2004–2009**



Source: BS, Eurostat, calculations by IMAD.

2.2.2. The importance of foreign sources of finance

Until the end of 2008, the financing flows of Slovenian enterprises were characterised by the prevalence of debt sources of finance and a gradual decrease of foreign sources of finance. However, 2009 and 2010, saw a dramatic reduction of debt sources of finance and the revival of foreign trade credits, equity capital and securities. Debt sources (loans and trade credits) accounted for 91.2% of all corporate financing flows in 2006 and 85.3% in 2008, while equity capital and securities accounted for only 8.8% and 14.3%, respectively. Prior to the crisis, domestic banks had been increasingly involved in the financing of the Slovenian business sector, with loans crowding out trade credits. The share of foreign sources in total corporate financing flows fell from 21.7% in 2006 to 13.9% in 2008. Such a drop was mainly attributable to the share of foreign equity capital in the total financing flows of enterprises that was down from 7.8 % in 2006 to only 1.8% in 2008. In 2009, the situation in corporate financing dramatically worsened. The flow of debt sources of finance turned negative, whereas the inflow from equity capital and securities remained positive. In 2009, enterprises net repaid foreign sources of finance in the amount of EUR 376 m. Such negative flow resulted from the repayment of loans and trade credits, while revenue from equity capital and securities was positive at EUR 463 m. In 2010, corporate financing from domestic sources

Table 2: **Corporate financing flows by financial instruments, 2006–2010 (EUR m)**

	2006	2007	2008	2009	2010
VALUE Total, EUR m	4,797	9,226	7012	501	1171
Slovenia	3,755	7,615	6038	877	-14
Foreign	1,042	1,611	974	-376	1185
Loans	3,032	6,223	5742	480	418
Slovenia	2,823	5,709	4782	890	223
Foreign	209	514	960	-410	195
Trade credits	1,343	1,930	269	-860	300
Slovenia	882	1,317	382	-431	-168
Foreign	461	613	-113	-429	468
Equity capital and securities	422	1,073	1001	881	453
Slovenia	50	589	874	418	-69
Foreign	372	484	127	463	522
Structure – total, %	100.0	100.0	100.0	100.0	100.0
Slovenia	78.3	82.5	86.1	175.0	-1.2
Foreign	21.7	17.5	13.9	-75.0	101.2
Loans	63.2	67.5	81.9	95.8	35.7
Slovenia	58.8	61.9	68.2	177.6	19.0
Foreign	4.4	5.6	13.7	-81.8	16.7
Trade credits	28.0	20.9	3.8	-171.7	25.6
Slovenia	18.4	14.3	5.4	-86.0	-14.3
Foreign	9.6	6.6	-1.6	-85.6	40.0
Equity capital and securities	8.8	11.6	14.3	175.8	38.7
Slovenia	1.0	6.4	12.5	83.4	-5.9
Foreign	7.8	5.2	1.8	92.4	44.6

Source: Bank of Slovenia, 2009a for 2006, 2010b for 2007, 2011b for 2008–2010.

[42] There is a risk that these loans will not be entirely repaid, which could also aggravate the problems of the Slovenian financial system in the future.
[43] Taking into account securities other than shares and other accounts receivable, in addition to loans.

continued to decrease, with a net outflow from enterprises amounting to EUR 14 m. Financing from foreign sources grew considerably to reach EUR 1,185 m, mainly in the form of equity capital and securities (EUR 522 m) and trade credits (EUR 468 m). Thus, in 2010 the most important source of finance of Slovenian enterprises was equity capital and securities (38.7%), while loans fell to 35.7% and trade credits rose to 25.6% (Table 2). It is therefore evident that in times of crisis enterprises have problems with domestic sources of finance, and that during the crisis debt sources of finance seem to be a much worse solution than equity capital and securities.

Between 2004 and 2007, the flows of foreign debt sources of corporate financing – both loans and trade credits – constantly increased while annual inflows of equity capital and securities stood still, only to become the most important foreign source of finance in 2009 and 2010. They amounted to just over EUR 400 m in 2004 (2005: EUR 425 m, 2006: EUR 372 m, 2007: EUR 484 m), fell to only EUR 127 m in 2008, but rose again in 2009 to EUR 463 m and 2010 to EUR 522 m. Thus, the share of equity capital in the total foreign financing flows went down from 52.6% in 2004 to 30.0% in 2007 and only 13.0% in 2008, grew to 123.1% in 2009, and accounted for 44.1% in 2010 (Table 3).

Table 3: **Foreign corporate financing flows, 2004–2010 (in EUR m and %)**

	2004	2005	2006	2007	2008	2009	2010
TOTAL, EUR m	731	819	1.042	1.611	974	-376	1.185
Structure – total, %	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Equity capital and securities	52.6	52.6	37.3	30.0	13.0	123.1	44.1
Loans	24.2	7.7	20.1	31.9	98.6	-109.0	16.5
Trade credits and other*	23.3	39.7	42.6	38.1	-11.6	-114.1	39.5

Source: Bank of Slovenia, 2009a for 2004-2006, 2010b for 2007, 2011b for 2008–2010.
Note: in 2007–2010 only trade credits.

The far most important among foreign total assets are short-term sources. At the end of 2010, loans (50.2%) and trade credits (13.1%) together accounted for 63.3% of foreign sources of finance, while foreign direct investments (FDI) accounted for 33.2% – a good third thereof are net liabilities towards associated companies, i.e. basically a credit relation between associated entities. Only a minimal 3.1% was held by foreign portfolio investments (FPI), of which 2.2% are equity shares and 0.9% debt securities (Table 4). The conclusion is evident: in Slovenia, FPI are an insignificant or at least unexploited source for financing the development of enterprises.

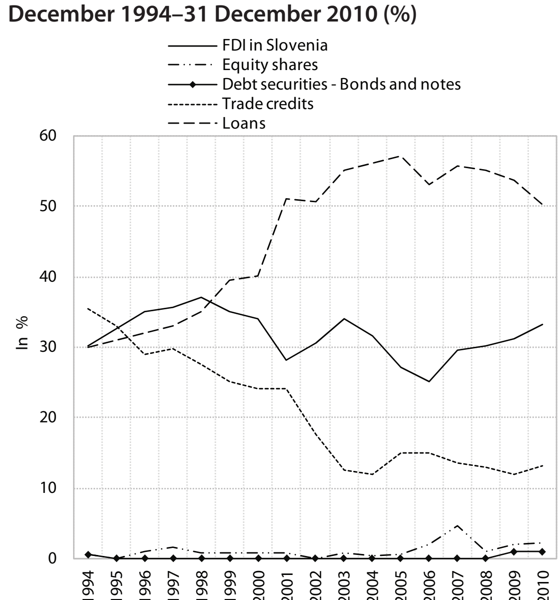
Table 4: **Stock of international investments of »other sectors« in Slovenia – liabilities by variables, end of 2010**

	EUR m	%
LIABILITIES OF "OTHER SECTORS " – Total	29.187,9	100,0
FDI IN SLOVENIA	9.694,2	33,2
Equity capital and re-invested profits	6.407,2	22,0
Net liabilities toward related companies	3.287,0	11,3
INVESTMENTS IN SECURITIES	898,1	3,1
Equity shares	648,1	2,2
Debt securities – Bonds and notes	250,1	0,9
TRADE CREDITS	3.819,2	13,1
LOANS	14.657,8	50,2
Banks	9.127,0	31,3
Other sectors	5.530,8	18,9
OTHER ACCOUNTS RECEIVABLE	118,6	0,4

Source: Bank of Slovenia, 2011a.
Note: Loans include bank liabilities from foreign loans since their final goal is to finance 'other sectors'.

As regards the structure of external financing of "other sectors", the past 15 years (1994–2009) saw a constant increase of loans and a downward trend in trade credits. The structural share of FDI was oscillating continuously yet persisted somewhat above 30%. FPI were low throughout the entire period and did not exceed 2.0%, with the exception of 2007 when they came close to 5%, and 2009 and 2010 when their share accounted for around 3% (Figure 37). Given such structure of corporate financing, Slovenia ranks among the EU countries with the

Figure 37: **Structure of international investments of 'other sectors' of Slovenia – liabilities by variables, 31 December 1994–31 December 2010 (%)**



Source: Bank of Slovenia, 2009b.
Note: Loans include bank liabilities from foreign loans.

lowest structural shares of FDI and FPI. In 2008, FDI inflow relative to GDP in Slovenia was 29.6%. At the EU level, lower shares were recorded only in Greece, Italy, Germany and Lithuania. In 2007, FPI accounted for 1.7% of Slovenia's GDP. In the EU as a whole, lower shares were recorded by Latvia and Romania (see Mrak, Rojec and Simoneti, 2010).

The main characteristics of capital inflows in Slovenia are heavy reliance on foreign debt sources, mainly bank loans, and a consequently low share of foreign capital inflows in the form of FDI and FPI. This means that Slovenia itself bears a disproportionately large share of related risks, which at the level of enterprises is reflected in the inefficiency of projects financed from such sources, and at the macroeconomic level in the shrinking of international capital flows in times of crisis. Slovenia's experience acquired in the current crisis shows that financing the dynamic economic growth through increased borrowing abroad may be very risky. Since foreign short-term debt sources were used to finance risky and long-term projects of Slovenian enterprises within the country and abroad, great risks accumulated in the national economy. Data on corporate financing flows in times of crisis clearly indicate that Slovenian enterprises have problems mainly with domestic sources of finance, and that during the crisis debt sources of finance turned out to be a less favourable solution, especially in comparison with foreign equity and securities. After a downturn in 2008, corporate financing from foreign equity capital and securities rapidly resumed and exceeded the pre-crisis values. This, however, cannot be said of foreign debt sources, particularly loans.

When, at the onset of the financial crisis, short-term foreign debts of domestic banks could not be renewed, the government was forced to introduce specific measures to ensure the stability of the domestic banking system. Other rapidly growing countries also made much use of strategic and portfolio investors rather than banks to finance development from abroad. In the financial crisis, this resulted in lower financial exposure of enterprises to banks in trouble and of these banks to the rest of the world. Portfolio investors investing in shares and strategic owners from abroad also had to bear their share of the risks owing to less favourable business conditions. This led to a different distribution of loss among domestic and foreign entities. Since banks were an important source of financing the economy in Slovenia, they will now also have to carry part of the burden of losses themselves.

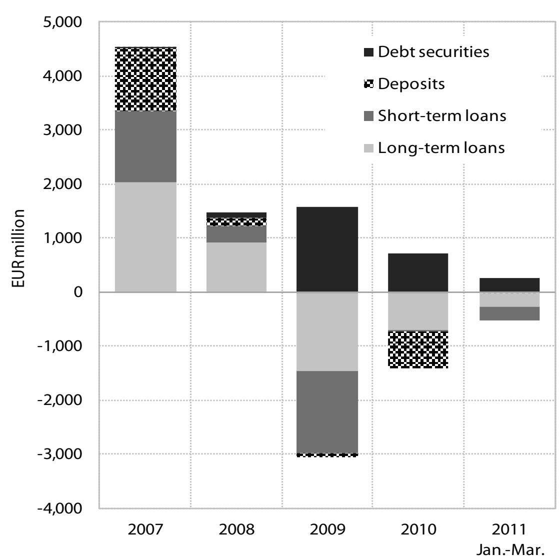
3. Bank sources

With the worsening of the financial crisis, the offer of bank sources shrank significantly. The sharpest decline was seen in foreign debt sources, mainly loans and deposits, which were not entirely compensated for by the issue of bonds. The shortfall of bank sources of finance was largely replaced by state deposits financed through additional government borrowing. The maturity structure of bank financing also improved thanks to long-term household deposits that increased considerably upon the onset of the financial crisis. Although in 2009 borrowing from the euro system remained an important source of financing, its importance decreased in 2010 following the gradual withdrawal of non-standard ECB measures.

3.1. Foreign sources

In the previous two years, the banking system's dependency on foreign sources did not decrease considerably. After having been considered the most important source for financing the Slovenian banking system, the net inflow of foreign sources fell significantly upon the onset of the international financial crisis. The banks thus continue to repay deposits and loans taken up abroad. In 2010, the banks net repaid foreign deposits and loans in the amount of EUR 1.4 bn, which is over 50% less than the year before. Despite significant net repayments of loans and deposits over the past two years, the

Figure 38: **Net flow of foreign sources in the Slovenian banking system between 2007 and the first quarter of 2011**



Source: BS.

dependency of the Slovenian banking system on foreign sources has not yet decreased considerably, while banks have, in contrast, intensified the issue of securities, which means that a large share of foreign claims due were restructured into claims with longer maturity based on state guarantees.

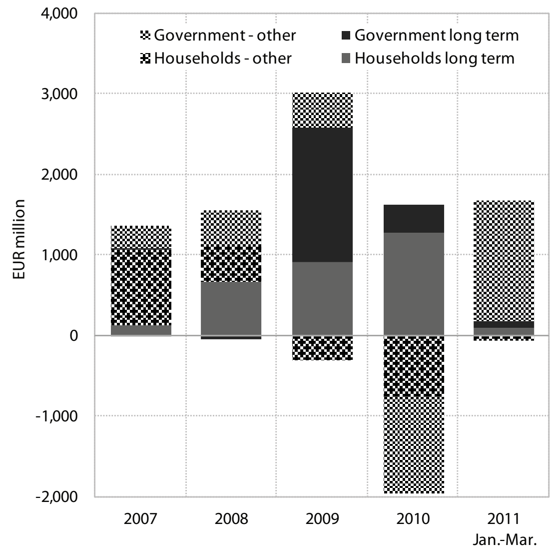
Since 2008, the share of liabilities towards foreign banks has fallen by slightly more than 6 p.p. to 28.4%. Their volume was down by a good tenth to EUR 15 bn. Based on data from the balance of payments, it is estimated that in 2010 the banks successfully refinanced a part of long-term liabilities due with short-term borrowing as net outflows of short-term loans were relatively low compared to the previous year.[44] The concentration of maturing liabilities to foreign banks has increased, which will additionally raise the liquidity pressures on the Slovenian banking system.[45]

3.2. Domestic sources and sources of the euro system

Domestic sources remain rather limited as well. In 2010, the inflows of household deposits recorded a downward trend for the second consecutive year and reached the lowest value in the last six years (since comparable data have been available). The only improvement was seen in the maturity structure of household deposits, which was mainly a consequence of the changed interest rate policy of Slovenian banks (see p. 95). Long-term deposits went up by EUR 1.3 bn; according to IMAD's estimates, they largely drew from net outflows of short-term deposits and deposits redeemable at notice. Their share in the total volume of household deposits in 2010 alone grew by 8 p.p. to 28%. The trends observed over the previous months indicate that inflows to long-term deposits shrank considerably, suggesting that such sources of banks' long-term assets are already very limited. Because of liquidity preference, households therefore prefer to keep part of their savings in the form of more liquid short-term deposits despite lower interest rates. The situation on the labour market does not seem to be improving much and it cannot be expected that the inflows of household deposits into the banking system will increase, which leaves the banks further dependent on other sources of finance.

[44] In 2010 they amounted to EUR 12.2 m, in 2009 to EUR 1.5 bn.
[45] As of 28 February 2011, the share of liabilities towards foreign banks with one-year maturity decreased only slightly; the share of liabilities with maturity between one and two years, on the other hand, increased significantly due to bank loans maturing in 2012. Within two years, almost a half of liabilities towards foreign banks will fall due, which is by 10 p.p. more than the year before.

Figure 39: **Net flows of government and household deposits into the Slovenian banking system between 2007 and the first quarter of 2011**



Source: BS.

After supporting the banking system in 2009 by issuing bonds and investing them in the form of deposits, in 2010 the government mainly drew deposits from the banks. Deposits thus fell by more than EUR 850 m. In 2009, the government tied up most assets in the form of long-term deposits, while in subsequent issues of bonds it invested the newly acquired funds as short-time deposits because of its own needs for liquid assets. Because of public finance sustainability, government deposits are a limited source of finance, which can mitigate the liquidity problems of the Slovenian banking system only in the short term.

Following the expansion of the financial crisis and the liquidity crunch, a more important role among bank sources of finance was assumed by ECB assets.[46] The latter intensified its activities in relation to longer-term refinancing operations, thereby providing funds with maturity of maximum twelve months. In 2008 and 2009, Slovenian banks significantly increased financing from ECB, which eventually exceeded EUR 2 bn and accounted for around 4% of the total bank assets. In 2010, when the ECB cancelled the longer-term refinancing operations with twelve-month maturity, the banks considerably reduced borrowing from ECB, which at the end of the year fell by more than 70% to EUR 602 m, the lowest value recorded in the past two years; the relative share in the total

[46] Gambacorta and Marques-Ibanez estimate that if the ECB – by means of non-standard measures – increased total assets of the banking system relative to GDP by 1%, lending activity in nominal terms rose by 0.5%.

assets decreased by almost 3 p.p. to 1.1% and was one third below the euro area average. If foreign sources of finance continue to be limited, it may be expected that Slovenian banks will again make larger use of the available sources of the euro system to repay the liabilities due.

The conditions for acquiring fresh total assets did not improve in the first quarter of 2011. The banks continued to repay deposits and loans of foreign banks and reduce their liabilities towards the euro system. A significant slowdown was also recorded in the net flow of household deposits into banks that were by almost three quarters lower than in the first quarter of 2010. Extremely negative trends were observed in March when net outflows – amounting to more than EUR 90 m – were the second highest after October 2008.[47] Total net outflows of foreign loans and deposits continued to slow down in the first quarter of the year. Previously amounting to over EUR 500 m, they fell by approximately one third compared to the same period last year, mainly as a consequence of this year's modest net inflow of deposits (EUR 17.7 m), whereas repayment of foreign loans more than doubled.

The banks thus obtained fresh assets mainly from the state. The latter invested a predominant share of its assets obtained from two issues of state bonds in the total amount of EUR 3.0 bn into banks in the form of deposits. Their maturity structure is rather unfavourable as practically all new assets are invested on a short-term basis. Another more important source of finance for the banking system is the issue of bonds by the SID Bank on international financial markets in the amount of EUR 350 m. Other liabilities were up by over EUR 300 m as well.[48] Based on detailed data from the balance sheet of the banking system, it is estimated that in 2011 the banks also increased trade credits as an additional source of finance. In the first half of the year, two banks raised their capital and thus obtained more than EUR 350 m of additional financial sources that were contributed mainly by the state, i.e. predominantly state-owned companies.

[47] Net outflows then amounted to approximately EUR 140 m.

[48] Including, e.g. liabilities towards brokerage companies, liabilities towards employees, payroll contributions, and other liabilities.

4. Risks to the lending activity

The Slovenian banking system is still exposed to risks that can significantly slow down the lending activity of Slovenian banks. Such risks are mainly on the side of: (i) reduced possibilities to refinance the liabilities due, (ii) rapid deterioration of the quality of bank investments and the related creation of bank impairments and reserves, (iii) low capital adequacy of banks, which reduces their possibility of obtaining fresh sources of finance and prevents them from assuming additional risks. Despite a reported gradual resumption of lending activity in the euro area, in Slovenia such activity continues to slow down. In the first quarter of 2011, enterprises and NFI net repaid loans taken out in domestic banks while government borrowing from domestic banks stagnated, because the government borrowed an additional EUR 3 bn on international financial markets by two issues of bonds. Another factor pointing to a possible further slowdown of lending activity is the trend recorded in household borrowing. The latter decreased considerably in 2011 and reached the lowest value since comparable data are available.[49] This could mean either that demand is lower or that banks, owing to the lack of resources, are unwilling to even credit households, which rank among less risky clients.

4.1. Reduced possibilities to refinance the liabilities due

According to data provided by the Bank of Slovenia,[50] more than EUR 3 bn of foreign liabilities will fall due in the next twelve months. According to estimates, should the possibility of refinancing the liabilities due deteriorate, the banks will be able to cover such by reducing the amount of their investments such as deposits at banks, deposits in the euro system, sale of equity shares and, partly, debt securities. Moreover, in the next twelve months, nearly EUR 4 bn of liabilities towards foreign banks will fall due and if banks are unable to obtain fresh financing sources by such deadline, they will be forced to reduce the volume of their investments more radically, which means an even more restrictive lending policy of the Slovenian banking system and thus poorer liquidity of the Slovenian economy.

Whether the banks will be able to refinance the liabilities due on international financial markets

[49] Since 2005.

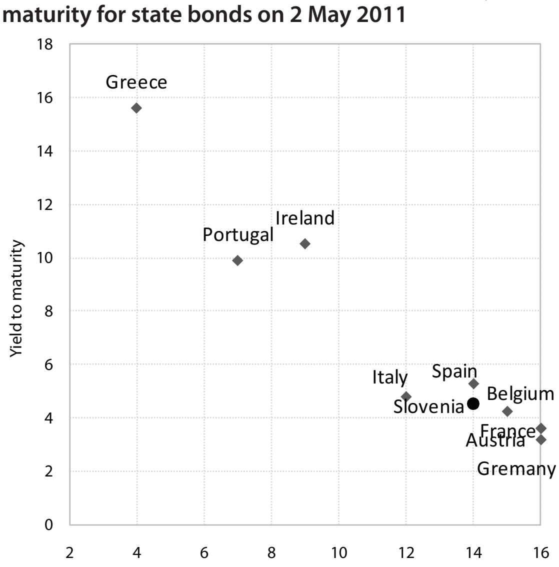
[50] As of 28 February 2011.

largely depends on the market situation and the general trust of creditors in the Slovenian state and financial system. Even a small change of the rating can make the access to foreign sources of finance more expensive, if not even significantly restricted. In fact, in the previous twelve months, interest rates for loans in the countries where ratings had already fallen and asked for financial support rose more than in other members of the euro area.

The European debt crisis strongly has strongly characterised the investors' attitude towards risks. Prior to that, the spreads of yields to maturity in countries with differing indebtedness levels were rather low but rose significantly on the onset of the crisis. This caused stronger pressures on public finance, which in turn worsened the credit conditions. The worsening of credit conditions for general government borrowing indirectly affects the borrowing terms of the banking system and of the entire economy. It is therefore essential that in times of instability, when small changes of the risk estimate strongly alter the borrowing terms, ratings do not decrease. Although spreads in other members of the euro area have widened, they have not increased considerably in Slovenia. Slovenia's rating remains unchanged, i.e. AA, although at the end of 2010 Standard&Poor's changed Slovenia's prospects to negative.

Although the correlation between lower ratings and yield to maturity of state bonds is hard to assess accurately, it is indeed positive. The figure shows yields to maturity in selected euro area member countries and their ratings, indicating that borrowing terms deteriorate along with the worsening of the ratings. Therefore, in times of financial market insecurity, it is even more necessary to ensure the conditions to preserve a relatively high rating.

Figure 40: **Correlation between S&P ratings and yield to maturity for state bonds on 2 May 2011**



Source: S&P, Eurostat.
Note: 16 on the x-axis means the best rating (AAA), while 4 means a rating of BB-, only achieved by Greece in April.

Table 5: **Credit default swaps on states and banks**

	Banks		State
	Simple average	Weighted average	
Greece	1060	1045	1530
Ireland	923	936	705
Portugal	654	656	680
Spain	319	274	248
Italy	151	159	153
Belgium	146	167	151

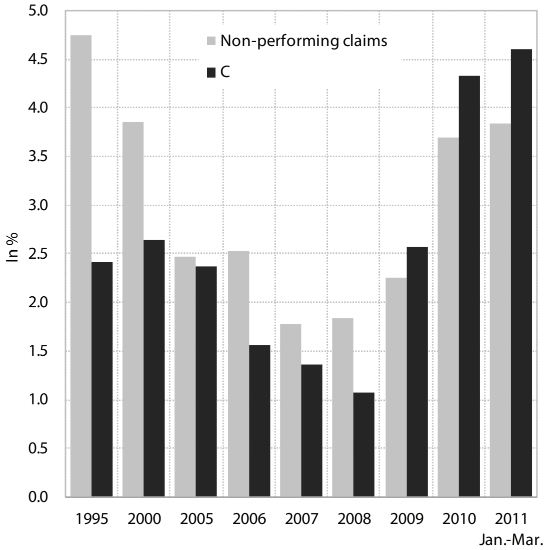
Source: Deutsche Bank. Credit Strategy Weekly, 28 April 2011.

During the crisis, when the situation in public finance and on financial markets is extremely unfavourable, the risks to public finance sustainability and financial stability are very much alike. The trends regarding borrowing costs for banks (measured by interest rate for credit default swaps - CDS) and the state are rather similar. Table 5 indicates that there are no major differences in CDS levels for the banking system and the state. For Slovenia, it may be assumed that the borrowing costs for the banks equal the interest rate that the banks pay for state deposits. Given a strong correlation between state and bank borrowing, it is necessary that domestic banks are adequately capitalised and that the government implements a fiscal consolidation in order to prevent an extreme deterioration of ratings and borrowing terms (see the chapter on public finance).

4.2. Deterioration of the quality of bank investments

The quality of bank assets began to deteriorate in 2009 and this trend further intensified in 2010. The total volume of non-performing claims last year rose by almost two thirds to EUR 1.8 bn, accounting for 3.7% of total exposure of the Slovenian banking system, which was the highest value recorded since 2003. Even higher growth was observed among claims with rating C; their share was the highest in the last 15 years (since comparable data have been available), showing that the quality of bank assets could worsen even further. Thus, in 2010, the banks created additional reservations and impairments in the amount of EUR 798.0 m, which was almost 60% more than in 2009.

Figure 41: **Non-performing claims and claims with rating C between 1995 and March 2011**



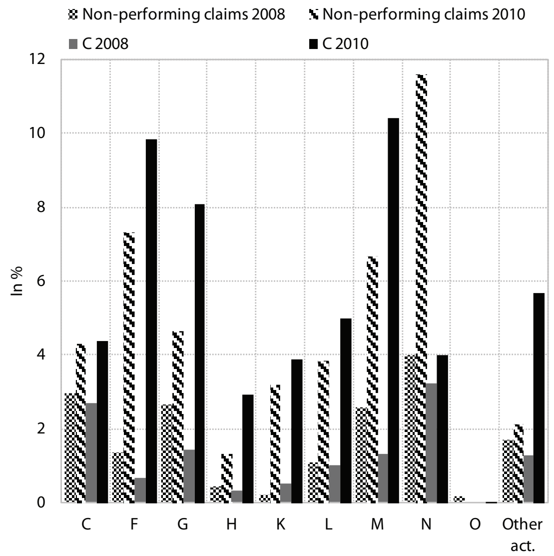
Source: BS, calculations by IMAD.

More than four fifths of the total increase of non-performing debts resulted from rapid worsening of the quality of claims towards domestic business entities, while the rest was mainly due to the deteriorating quality of foreign claims,[51] the volume of which doubled in 2010. Non-performing claims relative to the total exposure of Slovenian banks to economic activities in Slovenia thus rose from 2.2% to 3.9%. Their volume increased by four fifths or slightly above EUR 600 m. The deterioration of the quality of bank investments was accelerated by the banking system's exposure to enterprises involved in buyouts and those related to construction.[52] These enterprises together accounted for three quarters of all new non-performing debts in economic activities in Slovenia, and their amount tripled in 2010. The leader in such regard is construction, where in the last two years non-performing claims multiplied by 6.3 while the total of non-performing claims in the same period rose by around 115%. In the activities associated with buyouts and construction, non-performing claims at the end of 2010 equalled almost EUR 800 m. As regards other activities, such debts also grew slightly faster in wholesale and retail trade although turnover did not increase significantly in 2010 and still lagged considerably behind 2008. The year 2010 also saw a slight increase of non-performing foreign claims.

[51] Financial organisations excluded.

[52] These activities include: production of food, beverages and tobacco products, construction, financial and insurance activities, real estate activities, and professional, scientific and technical activities.

Figure 42: **Non-performing claims and claims with rating C by economic activities**



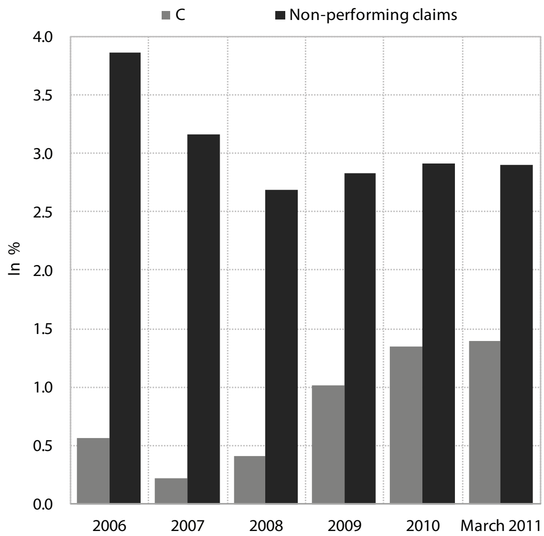
Source: BS, calculations by IMAD.
Note: C-manufacturing, F-construction, G-wholesale and retail trade, motor vehicle repair, H-transport and storage activities, K-financial intermediation, L-real estate activities, M-professional, scientific and technical activities, N-administrative and support service activities, O-public administration and defence, compulsory social security.

Despite an evident migration of debts into lower ratings, in 2010 the volume of claims on economic activities with a rating of C grew faster than in 2009. In fact, it reached EUR 1.9 bn. By IMAD's estimates, greater net flows into rating C may be due to the fact that the banks intensified lending to more risky clients, based on the guarantee scheme that allowed guarantees also to clients with a rating of C. At the end of the year, this group – which together with non-performing claims make up bad claims – comprised 5.5% of all claims on economic activities, which is two thirds more than the year before. The increase was most evident in wholesale and retail trade, construction,[53] information and communication, and professional, scientific and technical activities, while net inflows in financial intermediation decreased.

Households are the least risky bank clients since the quality of claims on households did not worsen considerably during the crisis. It is estimated that as regards households, currently most exposed to risk is the currency structure of their debts, yet the share of foreign currency loans has been gradually decreasing since the worsening of the financial crisis, thus reducing the risk of deteriorating quality of claims on households. Around 96% of all claims have ratings A and B, and around 3% are non-performing claims.

[53] In 2010, net inflows in construction amounted to EUR 170 m; in addition, there were heavy inflows into lower ratings as well since their volume in this period rose by over EUR 180 m.

Figure 43: **Share of non-performing claims and claims with C rating among households, in %, 2006–2011, end of the period**



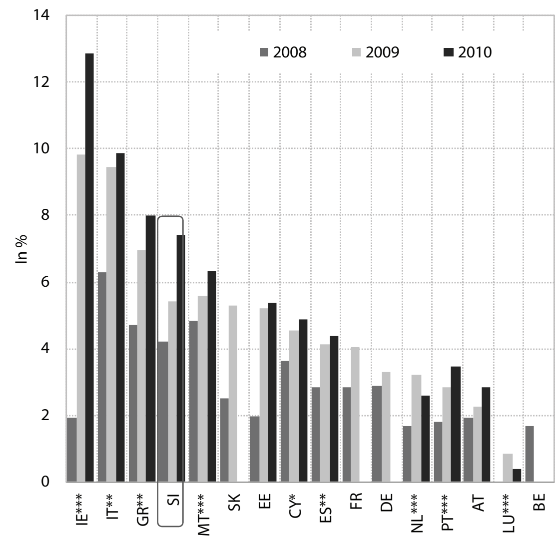
Source: BS.

The share of non-performing claims on households is rising much more slowly than in economic activities and does not deviate significantly from the level achieved in 2008 when it was the lowest ever (see Figure 43). Also, data on claims with rating C indicate that the quality of claims on households is decreasing more slowly: here, the share of C-rated claims rose less than in 2009, namely by 0.4 p.p. to 1.4%, which accounts for only a third of the entire banking system of Slovenia.

In the first quarter of 2011, the quality of bank investments further deteriorated. The total volume of non-performing claims thus rose by over 7% (last year by over 9%) and came very close to EUR 2 bn, thus accounting for 3.9% of total exposure of the Slovenian banking system, which is similar to the year 2000. With similar dynamics, the banks created impairments and reservations, which in the first three months of the year amounted to EUR 125.3 m. Here, too, the increase was mainly due to the rapid worsening of the quality of investments in sectors involved in construction, buyouts, and trade. A similar trend is observed in debts with rating C, mainly in construction (over EUR 200 m of net inflows, which is nearly equal to total net inflows for this rating), followed by transportation and storage (by EUR 31.5 m).

According to internationally comparable data, Slovenia ranked among euro area members[54] with the largest share of non-performing loans already in 2009[55]. In 2010, this share increased in most member countries. In Slovenia, non-performing claims grew by 2 p.p. and lagged only behind Ireland,[56] whereas such growth was less evident in other countries. This again points to greater worsening of the situation in the Slovenian financial system.

Figure 44: **Share of non-performing debts in individual countries of the euro area, 2008–2010 (in %)**



Source: Financial Stability Review, IMF-financial soundness indicators. Notes: *Data for q1 2010, **Data for q2 2010, ***Data for 2010.

4.3. Capital adequacy of banks

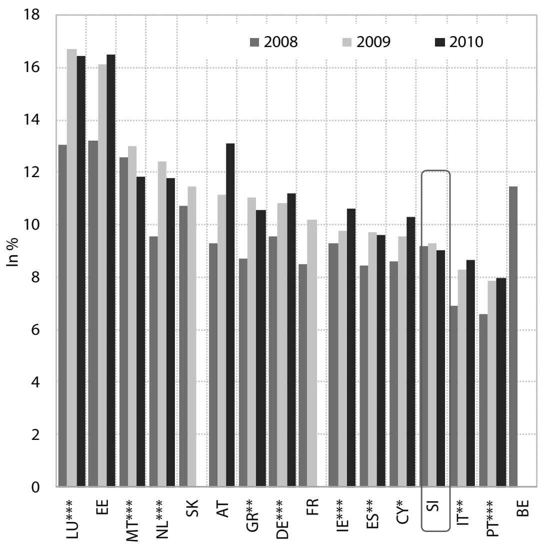
Research shows[57] that during the financial crisis the impact of the banks' capital adequacy on their lending activity is increasing. In such instable times, the providers of financial assets are much more cautious as regards the capital adequacy of the banks and their capacity to absorb potential losses. The banks with low TIER 1 capital compared to their risk-adjusted assets have less possibility of access to fresh sources of finance and obtain resources under less favourable terms than the banks that are strong in capital, which slows down their lending activity.

Measured by the Tier 1 capital adequacy ratio, the Slovenian banking system ranks among the less capitalised banking systems of the euro area. Between 2008 and 2010, the ratio decreased, while in

[54] No data for Finland.

[55] According to internationally comparable data based on IMF methodology, non-performing claims comprise claims with a delay of over 90 days while the Bank of Slovenia includes claims where the share of impairments and reservations exceeds 40%.
[56] With a growth of 3 p.p.
[57] See e.g. Gambacorta and Marques-Ibanez, 2011

Figure 45: **Tier 1 capital adequacy in the EU and in selected members of the euro area, 2008–2010 (in %)**



Source: Financial Stability Review, IMF-financial soundness indicators.
Notes: *Data for q1 2010, **Data for q2 2010, ***Data for q3 2010.

most other members of the euro area it grew. Limited access to fresh capital and lower capital adequacy are problems faced by those Slovenian banks that are not strategically linked with large foreign bank groups that could support them with sufficient capital to finance their operations. If low capital adequacy persists and the reduction of Slovenian banks' ratings continues, it can be expected that loans in the Slovenian economy will further shrink and that the already high active interest rates will grow even more. Even the two capital injections provided in the first half of the year will not suffice to place the Slovenian banking system among the euro area systems with a better capital standing. It is estimated that the Tier 1 capital adequacy ratio rose by less than 1 p.p.

In 2010, the Committee of European Banking Supervisors (hereinafter: CEBS) carried out stress tests for major banks in the EU in order to assess the banking systems' resistance to a possible further deterioration of the situation regarding credit, market and country risks. In Slovenia, the tests involved banks that are mainly foreign-owned, as well as NLB, which – on the assumption of the less favourable scenario[58] – would have a basic capital ratio by 0.3 p.p. higher than the lower ceiling of 6% in 2011. By the end of the first half of the year, CEBS intends to publish the results of the stress tests based on a slightly different sample. In addition to NLB and foreign-owned banks, the analysis will include NKBM. The less favourable scenario will include even more assumptions,[59] and it is estimated that the results of the stress tests for the Slovenian banks will be even worse than in 2010, particularly because the capital adequacy of the Slovenian banking system decreased.

[58] Including lower GDP and increased country risk.

[59] Unemployment, lower real estate prices, even lower value of state bonds.

5. Challenges

The main challenge in the Slovenian financial system is to prevent a further worsening of the situation. On the short run, it is necessary to ensure in particular (i) a strong capital base of the banking system able to re-assume risks, (ii) prevent the possibility of political interference with the restructuring of the banking system, and (iii) prevent migration of risks between the financial system and public finance, which will contribute to a more efficient consolidation of public finance. On the long run, it is necessary to provide for (i) withdrawal of the state from ownership in the financial system and the establishment of an ownership structure that will ensure greater efficiency thereof, and (ii) withdrawal of the state from the ownership of non-financial corporations. This would increase transparency and, together with the promotion of long-term savings for old-age, increase the importance of the Slovenian capital market in financing the Slovenian economy. Thus, a greater role in the financial structure of Slovenian enterprises would be assumed by, mainly, private equity capital and partly by long-term debt securities.

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