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Assessment and recommendations

Slovenia is gradually emerging from a deep recession

After steady convergence towards the European Union average in terms of GDP per capita, the Slovenian economy has been severely hit by the global crisis. Gross domestic product (GDP) fell by close to 8% in 2009, among the deepest declines in the OECD, but is poised to grow modestly in 2010 before growth picks up to 2-3% in 2011-12. The sharp drop in liquidity in the midst of the crisis required significant support to the financial system from the government and the European Central Bank. The financial health of households and firms has been weakened by reduced asset prices, incomes and the availability of credit. Although exports have rebounded strongly since mid-2009, domestic demand has been held back by the weak labour market and ongoing deleveraging by financial institutions and businesses. Needed fiscal consolidation will also constrain growth in the short term.

The banking sector should be further capitalised to reduce the risk of credit rationing

Since the beginning of the crisis credit risk has been growing, with a large increase in non-performing loans, and banks have been forced to increase the proportion of loans that are secured. Although the capital adequacy of the banking system was good overall, small domestic banks were less well capitalised. With business bankruptcies likely to increase further and falls in real estate prices expected to continue, concerns may arise as to whether the banking sector is sufficiently capitalised to withstand further shocks.

The Bank of Slovenia has issued new guidelines to ensure that banks have internal processes to assess and limit exposure to credit and market risks, and also called on Slovenian banks to further increase their capital buffers in early 2010. However, more needs to be done to ensure that the financial system is adequately capitalised, while taking into account the requirements of the Basel III accord. The publication of the EU-wide stress tests in July 2010 revealed that Slovenia's largest bank (NLB) was capitalised just enough to withstand a relatively lenient adverse economic and sovereign debt shock scenario. *The supervisory authorities should carry out stress tests for all Slovenian banks and disclose them appropriately. If needed, bad assets would have to be restructured and banks whose Tier 1 capital falls below safe thresholds would have to be recapitalised.*

Sustainable fiscal consolidation is required to foster confidence…

The fiscal position has deteriorated sharply, with the general government deficit reaching 5.7% of GDP in 2009. While spreads on 10-year government bonds over corresponding German rates at about 130 basis points are not among the highest in the euro area, they remain at a similar level to that prevailing in May 2010 at the height of significant tensions in some euro area sovereign bond markets. Consequently, it is important to foster investor confidence and ease banks' funding conditions in capital markets by pursuing consolidation efforts and ensuring the credibility of the overall strategy. Although the fiscal balance targets of the consolidation plan are appropriate, *all spending reductions planned through 2013 should be spelled out in full to reinforce market confidence*. Moreover, some of the measures taken to date are temporary and hence do not ensure a durable reduction in the structural deficit. Therefore, additional fiscal measures will have to be taken in 2011 and 2012 to head off the risk of sharp increases in long-term interest rates, insure against the risk of revenue slippages and achieve a permanent reduction in the deficit. A good start would be to *cancel – rather than postpone – the remaining steps of the public-sector wage increases,* which go beyond the compensation for past under-indexation of wages to inflation. This has led to significant increases in public sector wages since 2008. Moreover, there is room for raising taxes on immovable property; the ongoing reform of the related tax bases creates an opportunity in this respect. Increasing environmental taxes could also be an option, though they are already quite high. There are discussions over setting a cap on social security contributions, but in the current weak fiscal environment the government needs to consider how the loss in revenue will be offset.

… and the new fiscal framework should help

A rule-based fiscal policy is useful to foster investor confidence. The government has recently adopted a new fiscal rule capping expenditure increases at the rate of potential output, which should help the consolidation process. *The rule should be strictly implemented to establish its credibility and its effectiveness subsequently assessed. It might be improved by increasing transparency regarding the fiscal targets and the parameters underlying the convergence speed to these targets. In particular fiscal ceilings may need to be reconsidered to ensure a reduction in the structural deficit consistent with a medium-term objective which pre-funds a large share of contingent liabilities, notably those related to ageing*. Indeed, despite the significant draft reform, pension outlays are projected to increase by around 7% of GDP by 2060. Long-term objectives could be best achieved by *adopting multi-year ceilings (beyond the current two years) and excluding cyclically-sensitive expenditure (in particular unemployment benefits)*. To ensure effective implementation of the fiscal rule, *fiscal projections should be produced by an independent institution. Therefore, the government should assure the transparency and consistency of macroeconomic forecasts by making the Institute of Macroeconomic Analysis and Development (IMAD) the only source of the macroeconomic assumptions used for the budget law, as was the case prior to summer* 2010. The creation of a fiscal council is welcome, but the government should consider strengthening its administrative and analytical capacity notably to allow it to assess deviations from the rule.

The proposed pension reform is a step in the right direction…

Slovenia is faced with unsustainable public finances in the long term due to ageing costs, particularly if the pension system is not reformed. The government has prepared a draft of a new pension reform which passed Parliament in December 2010. The major changes proposed by the legislation are to: *i)* increase the statutory retirement age to 65 and the minimum pensionable age to 60 for both men and women; *ii)* introduce steeper penalties for retiring early (and bonuses for people who continue working after becoming eligible for full pension); *iii)* extend the pension reference period to the 27 best consecutive years of contributions; and *iv)* index pension benefits partially to inflation (and not only to wage growth). Some welcome additional measures aim to improve work incentives of older people by allowing individuals to combine pension benefits and work more flexibly and reducing employer social security contributions for older workers.

… but a more comprehensive reform is needed to address the issue of long-term fiscal sustainability

The proposed pension legislation brings many welcome changes, but its budgetary impact, while significant, falls well short of the projected long-term financing needs. One of the main reasons is that the replacement rate will be permanently fixed at around 60%, although it would have been progressively lowered to below that level without the reform. The weight of wage growth compared to inflation in the proposed benefit indexation formula is high and past earnings are still revalued solely on the basis of nominal wage growth. *The government should lower the replacement rate while encouraging the private pension system. One possibility would be to reduce the rate at which benefits accrue or revalue past earnings in the calculation of the pension reference salary in line with past inflation or some combination of past inflation and wage growth (such as the Swiss formula, which attaches equal weights to each), instead of wage growth only.* Additional reforms should be introduced to ensure that public finances are on a sustainable footing. *The minimum pensionable age should be further increased to better align it with the statutory retirement age. The penalty for early retirement should be raised to a level consistent with actuarial neutrality. Pension parameters, such as the minimum and full pensionable ages and contribution requirements, should be closely linked to gains in life expectancy. Consideration should be given to eventually transforming the current defined benefit scheme into a notional defined contribution scheme.* The Slovenian pension system continues to grant somewhat more favourable conditions to women than to men. *Differences in the contributory period requirements for men and women should be eliminated.*

Boosting competitiveness by rebalancing the economy is key to resuming convergence

The crisis has revealed important weaknesses in Slovenia's economy. Prior to the crisis, growth was highly dependent on credit and construction activity, and exports were too reliant on cyclically-sensitive goods, compared to other euro area and Central and Eastern European countries. This export specialisation has limited productivity gains in the traded goods sector and has increased Slovenia's vulnerability to global cyclical downturns. According to various estimates, Slovenia's potential growth rate is likely to be somewhat

reduced in the aftermath of the crisis. Hence, a major long-term challenge will be to boost trend productivity growth so that living standards continue to converge on the OECD's best performers. Structural reforms to boost productivity and competitiveness should concentrate on improving labour market flexibility, fostering innovation and higher education, and favouring foreign direct investment, notably by reducing the direct involvement of the state in the economy.

Improving labour market functioning is essential

Growth could be hampered by the inflexibility of labour market institutions in Slovenia. Despite recent reforms that reduce notice periods and the generosity of severance payments, and widen the eligibility criteria for temporary jobs through the so-called "mini-jobs" bill, employment protection of regular workers remains amongst the tightest in the OECD. *Employment protection should be loosened by further reducing the administrative burden on individual notice and dismissal, relaxing the criteria under which dismissals are legitimate and further reducing the generosity of severance payments.* The decision to increase the already generous minimum wage (close to 50% of the median wage in 2009) by 23% in early 2010, motivated by the willingness to catch up with the cost of living, and the recent rapid growth in public sector wages both threaten to weaken economic performance. To compensate for the steep increase in the minimum wage, *the government should index minimum wages only to inflation for a prolonged period, to reduce their level relative to the median wage over time.*

Enhancing innovation policies should help Slovenia to get closer to the efficiency frontier

Slovenia scores rather well in terms of innovation input indicators (research and development expenditure, the number of researchers, etc.). However, output indicators (*e.g.* high-growth innovative firms, high-technology exports and the number of patents) point to low and even declining efficiency of overall innovation efforts. One of the main factors constraining innovative efficiency relates to the organisation of government innovation policy, which is marked by administrative dispersion, a lack of coordination among stakeholders and a consequent "implementation deficit". *The government should reduce administrative dispersion and overlap among various stakeholders of innovation policy by improving information flows and transparency among ministries and associated agencies.*

New reform proposals (including the creation of a new umbrella Council for Innovation Policy run by the Ministry of the Economy and the Ministry of Higher Education, Science and Technology) go in the right direction, but are unlikely to be successful as long as regular, in-depth consultations among major stakeholders of innovation policy fail to respond to the needs of the business community. The authorities agree that entrepreneurial demand should be given a more decisive role in allocating public research funds, but this shift in public research and development policy is bound to meet with strong resistance from the public research community. Further measures are needed to reduce the "stand-alone sector approach" of innovation policy, which isolates it from other supply-side policies. For example, *the government should consider giving financial incentives, such as "research vouchers", to companies, which would then contract with public research centres for research services.*

School performance is good…

The Slovenian primary and secondary education systems perform well by international comparison, and Slovenia has one of the highest shares in the OECD of the population aged 25 to 64 to have completed at least upper secondary education. Scores in the Programme for International Student Assessment (PISA) are above the OECD average. At the same time, tertiary attainment rates are below the OECD average, even though the attainment rates of young workers are significantly higher than those of older workers. With current graduation rates still below the OECD average, the gap in tertiary attainment rates of the working age population *vis-à-vis* the OECD average is set to linger. Despite favourable employment prospects and high private returns to study, the share of science and engineering graduates is low by international comparison.

… but vocational programmes need to be made more attractive to pupils and more relevant to labour market conditions

The interest in short vocational programmes has been waning in Slovenia, creating a skill deficit. *In order to encourage pupils to go into vocationally-oriented programmes, the education system should facilitate a more flexible transition from vocational to academic tracks and consequently direct access to higher education.* Employers in Slovenia have little influence on school curricula. *Their involvement in vocational education needs to be further increased to equip vocational education graduates with the skills demanded by the labour market.*

Improving spending efficiency through reducing costs in early childhood and compulsory education is a challenge…

The share of children enrolled in early childhood education and care (ECEC) has been increasing steadily in Slovenia, helping children from disadvantaged backgrounds in particular. The government has been taking some measures to further expand ECEC. Nonetheless, the costs of ECEC are high by international comparison. *The authorities should improve spending efficiency in ECEC provision and boost supply by allowing pupil-teacher ratios to increase.* As the geographical distribution of ECEC facilities is not optimal, with excess demand in larger cities in contrast to smaller towns, the authorities should *reduce the geographical mismatch between available child-care places and demand.*

Relatively good outcomes at the primary and secondary levels are also achieved at a high cost. Slovenia spends considerably more on basic education on a per-pupil basis than other countries with similar income levels. Average class sizes in primary and lower secondary education are comparatively small. Also, Slovenian schools employ the highest number of professional support staff per pupil in the OECD. *The compulsory education system should be restructured to reduce operating costs by merging and closing schools that serve too few students, and extending catchment areas, while taking into account other socio-economic considerations. Surplus teaching and non-teaching staff should be rationalised by not replacing retiring staff in full. If this falls short, appropriate redundancy packages for surplus staff could be provided.*

... as is achieving better tertiary education outcomes

Completion rates in tertiary education are somewhat low in Slovenia as compared to the OECD average. Also, Slovenian students take almost seven years on average to complete their studies at the undergraduate level, which is among the longest in the OECD. The share of repeat students in full-time undergraduate programmes is very high, though slowly declining. To speed up the completion of tertiary studies, the government should *introduce universal tuition fees in tandem with loans with income-contingent repayment, which would also ensure wide and equitable access*. Tuition fees would make students more receptive to labour market signals and encourage them to complete their studies in a timely manner. Tuition fees would also allow higher education institutions to raise a greater share of their funds from private sources and if those institutions were given scope to set their fees, it would stimulate competition.

Resources devoted to higher education, as measured by spending per student, are low by international comparison and relative to other levels of education in Slovenia; it is the only OECD country where per-student spending at the tertiary level is less than that at lower levels of the education system. Rapidly changing technologies and international competitive pressures make it essential for Slovenia to boost tertiary education outcomes and provide adequate resources to the higher education system. *Public funding available per student at the tertiary education level should be increased, notably through enhanced spending efficiency at all levels of education.*

The higher education funding mechanisms in Slovenia should also be overhauled to enhance tertiary education outcomes. For instance, to give higher education institutions incentives to ensure timely completion of studies, the authorities should *take into account student progress when allocating funding to higher education institutions*. In addition, public funds are currently allocated to higher education institutions through a mechanism that has a fixed component representing the grandfathered element and a flexible part linking funding to their inputs and outputs. The fixed part has a relatively large weight. This arrangement favours large and historically well-established institutions, rather than efficiency considerations, and fails to maintain adequate levels of funding per student when the expansion of tertiary education is rapid. *The fixed element in the funding mechanism for higher education system should be phased out to better meet institutions' financing needs.*

The share of foreign students studying in Slovenia and Slovenian students studying abroad were among the lowest in the OECD in 2007. *Adequate financial support should be made available to students studying abroad. Study programmes that are more attractive to foreign students should be developed, and the authorities should relax restrictions on offering courses in non-Slovenian languages.*

Boosting foreign direct investment will help to raise efficiency

Aggregate productivity levels have converged rapidly on the euro area and OECD average since Slovenia began the transition to a market economy in the early 1990s, but productivity remains low in a number of industrial sectors with high public and low foreign ownership. Slovenia's high-technology manufacturing sector is underdeveloped compared

to some other Central and Eastern European countries (CEECs). Slovenia's stock of foreign direct investment (FDI) has grown more slowly than that of other CEECs over the past two decades, limiting the adoption of new technologies and ensuing productivity gains. Its FDI share exceeds that of other CEECs only in financial intermediation, with much lower shares across all other sectors of the economy, particularly in manufacturing and network industries, such as energy and telecommunications.

Slovenia has improved policies to encourage greater FDI by opening the privatisation of state-owned assets to strategic investors, improving incentive schemes aimed at attracting foreign investors and providing a competitive regime for corporate taxation, with tax relief for investment and depreciation. Although its regime of direct financial incentives for foreign investors has moved closer to best practice, the system appears too biased towards export industries, and there has been little empirical evaluation of the costs and benefits of the existing regime. *The authorities should review existing direct financial incentives and the performance of the special economic and customs zones to make sure that such support is cost effective and is not biased against investment in the non-traded goods and service sectors.*

Other aspects of the enabling environment for foreign investment also need to be improved. Employment protection legislation in Slovenia is amongst the most rigid in the OECD and both surveys of foreign investors and cross-country empirical research suggest that Slovenia's labour market institutions are inhibiting foreign investment. This is another argument to reduce employment protection for regular contracts. It is more difficult to acquire and develop land in Slovenia than in most other CEECs and capital markets are very shallow. *Procedures for accessing business premises and acquiring land and building permits should be streamlined. The depth and liquidity of capital markets should be increased through listing partially privatised state-owned enterprises on the stock market, improving competition for brokerage services and relaxing requirements for minimum pension fund returns.*

Productivity and FDI would be enhanced by rationalising public ownership and improving governance

Public ownership and control of enterprises operating in the market sector of the economy is widespread in Slovenia. Its score on the OECD's product market regulation indicator is worse than most of its CEEC peers and other OECD countries, largely because it performs poorly on the public ownership component of the indicator. Enterprises directly owned by the state are most commonly found in network industries, banking and insurance. In addition, the state indirectly holds at least a minority controlling interest in more than 50 companies through its ownership of KAD, the pension fund, and SOD, the restitution fund. Many of these firms operate in sectors of the economy, such as manufacturing, in which it is unusual amongst developed economies for the state to have a controlling interest. Five of the nine largest firms listed on the Slovenian stock exchange are effectively controlled by KAD and SOD.

As part of its accession to the OECD, Slovenia has started to transform the management of its public asset portfolio and improve corporate governance. It has recently created a central ownership Agency to manage the public asset portfolio on behalf of the state and define the ownership objectives for the state. *To carry out its ownership functions on behalf of*

the state properly, the Agency must be competent, well resourced and subject to high standards of accountability and transparency through an effective internal corporate governance regime. The authorities should also put in place a high-quality corporate governance regime for enterprises that remain state-owned and make sure that the rights of non-state minority shareholders are enhanced. The state should not be involved in the day-to-day management of state-owned enterprises, and boards should be composed of experts and professional board members who are independent of the government.

One of the most important tasks for the new Agency will be to develop a strategy for the future management of public assets. This will then enable it to establish a framework defining which assets should be retained in public hands, privatised or wound down. Accelerating the privatisation process would, if done correctly, significantly boost productivity in a number of key infrastructure sectors. It would also probably deepen Slovenia's capital market and help improve the corporate governance frameworks. *The agency should undertake regular, transparent, quantitative analysis of the costs and benefits of keeping individual assets in state hands. In parallel, the authorities should make the two state-owned investment funds more independent of government and reduce them to portfolio investors over time. They should also ensure that the privatisation process is well managed and supported by the public.*

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