

Assessment and recommendations

A successful economic catch-up over the last decade

Since 1997, Slovenia has enjoyed dynamic growth, steadily moving toward the OECD average gross domestic product (GDP) per capita. Strong growth reflected a favourable business environment and significant structural reforms that paved the way to European Union (EU) accession in 2004. Prudent macroeconomic policies also helped to maintain growth without creating any major imbalances, until recently. In particular, the social agreement of 2002 to keep wage growth below that of productivity helped to reduce inflation toward the level in the euro area within a couple of years. The agreement also contributed to improved competitiveness while preventing a significant deterioration in the current account balance, in contrast to the experience of many other transition economies. A strict agreement on public wage restraint since 2004 and cautious implementation of the two-year budgeting rule helped bring the fiscal balance back to surplus in 2007. These positive developments suggest a sustainable catch-up during this period. However, some signs of overheating emerged after euro area entry in 2007, which coincided with strong food and energy price shocks, with inflation peaking mid-2008 at the highest level within the euro area and unemployment falling significantly below its estimated natural rate.

Economic convergence is now challenged by the global crisis

The main channel through which the global crisis has affected Slovenia is trade, as foreign demand, especially from Germany, has fallen sharply. The worst-affected sectors have been those producing cyclically-sensitive goods, such as the automobile sector (1.1% of Slovenian value-added). Slovenia's banking sector has not been spared by the financial crisis either, despite not being directly exposed to the toxic assets. The banking sector has been facing refinancing difficulties since the last quarter of 2008. Both foreign and domestic banks had been borrowing abroad in recent years to finance a credit boom that outstripped the growth of domestic deposits. As a consequence, the total amount of short-term debt to be refinanced within a year has reached EUR 5.5 billion, about a sixth of Slovenian GDP, forcing banks to hold cash and limit credit to households and firms. The economy of Slovenia is expected to enter into recession in 2009 and slowly pick up in 2010. This outlook remains fragile as it relies on a recovery in exports and on the effectiveness of recent policies to support growth.

Measures to support the financial sector and avoid credit rationing have not yet resulted in a pickup in bank lending

The government, with the help of the Bank of Slovenia, is actively supporting the banking system, but with mixed results so far. A state guarantee scheme (allowing up to EUR 12 billion of bank refinancing to be guaranteed by the state until end-2010) was put in place last year but only one bank has applied. The government took new measures at the beginning of 2009 to support bank refinancing and to help banks resume lending. To support bank liquidity, the government used its higher credit rating to borrow EUR 1 billion and deposited most of the proceeds in bank accounts. The government has also used three instruments to give incentives for banks to resume or keep lending to the domestic firms: a state guarantee (up to EUR 1 billion in total) for which banks can apply when they lend; credit lines from the state-owned export and development bank (SID), whose recapitalisation decision has been approved; and direct state guarantees when firms borrow in financial markets. Having started in 2009, the positive impact of these measures on bank lending has not yet been clearly felt. Should they fail, the government has also been contemplating direct lending to firms, or even more radical options to support the banking system, such as purchasing assets directly from banks, recapitalising them or creating a “bad” bank. Despite the difficulties in the financial sector, household confidence in bank deposits has not been affected thanks to the removal of the ceiling on the state guarantee for deposits.

In this context, there is room for discretionary fiscal policy

The favourable fiscal position built up before the crisis hit has provided room for fiscal stimulus. The revised 2009 budget goes beyond automatic stabilisation and incorporates a discretionary stimulus amounting to 1.2% of GDP. Including measures to increase public wages decided in July 2008 raises the discretionary fiscal impulse to about 2% of GDP in 2009. With an expected strong impact of automatic fiscal stabilisers, the general government deficit is expected to be close to 6% of GDP in 2009.

But policy measures that put long-term fiscal sustainability at risk should be avoided

Slovenia should prioritise discretionary fiscal measures that help foster its potential growth, including public investment, spending on human capital or research and development. Measures whose only purpose is to support short-term activity should clearly be made temporary and removed as soon as activity picks up. In this respect, composition of the stimulus package is mixed. On the positive side, it contains a recapitalisation (EUR 160 million) of the state-owned export and development bank to support lending to firms as well as diverse tax measures to support investment (about EUR 100 million). On the other hand, the main government fiscal measure (EUR 230 million), which subsidises firms for reduced working hours to maintain employment, may prove difficult to reverse and lead to a reduction in potential output if kept in place too long. The government should also reconsider its planned increase in public wages, since this will permanently raise public spending by roughly 1% of GDP at the expense of long-term fiscal sustainability.

And fiscal policy needs to pay attention to the appropriate policy mix

Taking into account the usual time lag for fiscal measures to kick in, the Slovenian government will need to progressively withdraw the fiscal impulse as soon as the economic prospects start improving, probably from 2010 or 2011 onwards. For this purpose, a strong political commitment is needed to restore a balanced fiscal position over the medium term in the context of the Stability and Growth Pact. Ways to foster this commitment would be to introduce *performance budgeting* and consideration can be given to *put in place an independent Fiscal Council that regularly assesses the appropriateness of the fiscal stance and long-term sustainability*. As a catching-up economy with monetary conditions which may be easier than in other euro area countries, it is important that *the fiscal stance takes into account the actual monetary conditions in Slovenia* so as not to repeat what happened after euro area entry, when fiscal policy was *de facto* not sufficiently restrictive to provide an appropriate policy mix *vis-à-vis* the euro area monetary stance, which was relatively loose for a booming economy. This would help to keep inflation at a level closer to the objectives for the euro area as a whole.

Beyond the crisis, efforts toward real convergence should be renewed

Beyond 2009 and as the economy recovers, efforts to achieve real convergence towards the euro area average need to be renewed. Entry to the euro area was supported by the 2002 social agreement of keeping wage growth below the growth of productivity. The implementation of the law reducing wage disparities in the public sector should be reviewed in light of its macroeconomic impact, since this law will result in a higher fiscal deficit and add to wage pressures once the economy recovers, potentially damaging employment and competitiveness if wage growth remains durably above productivity growth. *A new social agreement ensuring that real wage growth does not exceed that of trend productivity is necessary.*

The speed of real convergence will depend critically on the scope of structural reforms. Slovenia has achieved a broad modernisation of its economy since independence through the gradual implementation of structural reforms. This gradualism in reforms brought positive results, such as maintaining low inequality and consensus for market-oriented reforms. However, gradualism also entails costs. As some reforms were only partial, especially in the labour and product markets, Slovenia could not reap all the benefits from previous reforms in other sectors (trade, finance and tax policy). Moreover, in the long run, structural reforms are key to ensure resiliency to shocks within a common currency area. Looking ahead, the rapid ageing of the population will reduce potential output growth. To foster further convergence, structural reforms need to be accelerated, and bad times should not be used as an excuse for postponing the political discussion on the necessary reforms. Toward this end, policy makers need to shift attention to reforms to increase labour supply and foster productivity growth through enhancing the business environment, while restoring fiscal prudence to maintain a macroeconomic framework conducive to growth.

Fiscal sustainability requires improved expenditure efficiency and structural reforms, especially further pension reform

Since 2002, Slovenia has followed prudent fiscal policies, leading to a significant improvement in both the actual and structural deficits. But this success should not lead to complacency as the improvement in the underlying position is weaker than it appears. Volatile tax elasticities led to exceptionally high tax receipts that have been hiding part of the fiscal cost of recent tax reforms. Expenditure restraint was helped by an agreement to partially index public sector wage growth to inflation, which also contributed to ease qualification for euro adoption, a policy which has now resulted in large public wage increases. The improvement in the fiscal position also reflected a build-up of contingent liabilities in the area of highway construction; the public company in charge of highways may not be able to raise enough revenues from tolls to reimburse its debt while fulfilling its maintenance duty. On top of that, long-term liabilities related to ageing remain daunting. There is general agreement among the experts that the 1999 pension reform has not been adequate to ensure long-run sustainability. According to estimates by the European Commission, the degree of ageing in Slovenia will be the second most pronounced in the EU, and the total ageing costs will rise by about 13% of GDP by 2060.

To maintain fiscal sustainability, the strategy of pre-funding part of ageing costs should be resumed as soon as the crisis subsides, by running a balanced budget over the medium term. Consolidation achieved through expenditure restraint being more sustainable, the government should supplement the rules of the Maastricht Treaty and the Stability and Growth Pact by a public expenditure rule designed to ensure a gradual decline in expenditure as a share of GDP. Improving education and health efficiency, linking spending performance more tightly to budgeting and better targeting social transfers would also help control expenditure growth.

Pre-funding of ageing costs, however, cannot be the sole strategy to accommodate the upcoming expenditure arising from ageing, because the sizeable fiscal surplus implied is not likely to be politically feasible or economically desirable. Accordingly, renewed efforts to contain ageing costs through pension reforms should not wait for the economic situation to improve. In particular, a reform of the pension system should aim at raising the effective retirement age and lowering the replacement rate (e.g. by shifting the indexation of pensions from wages to prices or extending the contribution period to receive a full pension). The government should therefore consider transforming the current defined benefit scheme into a notional defined contribution scheme, or if the defined benefit system is continued, introducing an automatic adjustment of the retirement age to life expectancy.

Labour force participation should be increased while reducing labour market dualism

The labour market situation has improved markedly over the past years, with the unemployment rate falling below its estimated natural rate and the employment rate rising to a level above the OECD average before the financial crisis hit Slovenia. The improvement in the labour market is partly owed to the recent buoyant growth but also to important structural reforms: reductions in the labour tax wedge, a tightening of the

eligibility for unemployment benefits and the introduction of active labour market programmes. Nevertheless, several challenges remain which require further reform efforts.

- *The authorities should refrain from taking counter-cyclical measures during the crisis that have a long-lasting negative impact on labour market functioning. As mentioned previously, subsidising shorter working weeks should not continue beyond the crisis. Also, the ratio of the minimum wage to the average wage is still high by international comparison and should not increase and, preferably, be reduced further.*
- *The labour force participation rate of the elderly is still very low by international comparison, despite some recent improvements. To raise participation rates, the pension system needs to be reformed further by increasing the retirement age, removing incentives for early retirement and facilitating gradual exits from the labour force. To ensure that those who wish to work longer also find appropriate jobs, a continuous upgrading of skills is essential and an evaluation of adult education programmes should be conducted.*
- *To increase employment rates of the younger age cohorts, the length of tertiary studies needs to be reduced by strengthening incentives for rapid graduation. Important steps in this direction could include making the eligibility for student benefits contingent on an annual minimum study progress or introducing tuition fees together with student loans with repayments contingent on earnings after graduation.*
- *Hiring and firing costs should be eased for regular work contracts to ensure that workers do not get trapped in temporary forms of employment and hence avoid increasing labour market dualism. This should be done once the economy recovers as easing employment protection during the crisis is not an appropriate option.*

Further tax reforms should also help increase labour demand

Tax policies should focus on reducing employer contributions to social security. To compensate for revenue losses, the government should raise property taxation and, by broadening tax bases, indirect taxes as well. An increase in the value added tax rate could also be considered in the medium run. The government should also improve the design of environmental taxes by strengthening the link to pollution.

The overall business environment is good but could be improved by increasing the powers of the Competition Protection Office

Slovenia's rapid catch-up owes much to a favourable business environment. Slovenia's 2008 level of the OECD product market regulation index is much lower than those of neighbouring transition economies, being close to levels noted for more developed adjacent countries. Keener competition since EU accession has set the stage for the creation of large numbers of small and medium-sized enterprises. Nonetheless, foreign direct investment (FDI) inflows have remained low, pointing to a sub-optimal transfer of best-practice knowledge. In key service sectors (retail sector, financial services, energy and telecommunications), low contestability linked to state involvement and strong market concentration may have deterred inward FDI.

In order to strengthen competition, the Competition Protection Office (CPO) should be separated from the Ministry of Economy, becoming an independent agency with its own budget. For this measure to be effective, the government will need to grant sufficient resources to the CPO so that it can fully operate without the administrative support of the Ministry of Economy. Another measure to enhance competition is to strengthen public procurement to rule out potential collusion among tenders, given that the total amount of public procurement per year plays a significant role for the Slovenian economy (almost 10% of GDP).

There is a need to reduce barriers to entrepreneurship and improve innovation policies

The life profile of companies in Slovenia points to a general lack of entrepreneurial dynamism, which has limited overall efficiency gains. Options to strengthen entrepreneurship include *facilitating property registration and expanding the network of public/private business support centres*. The quality of Slovenia's future business environment depends, to a large extent, upon the introduction of an effective *innovation policy, which could be supported by multi-purpose centres*.

Enhanced business efficiency also demands improved governance of state-owned enterprises before eventual privatisation

As the efficiency of state-owned enterprises is low, privatisation should be resumed once the economic situation improves. In the meantime, *the government should publish a list of state-owned companies and prepare a privatisation plan. The government should also explore ways to improve the management and governance of state companies*. Involvement of the State or state-managed funds in company management, for example to use state-owned companies to support some sectors of the economy, should be avoided. *In underperforming state-controlled companies, the government should implement strategic plans to raise productivity to levels observed in other EU countries. To this end, the government should ensure that competent supervisory boards appoint managers based only on expertise*. The government has established an independent Council for Accreditation of Staff of public companies which is a step in the right direction.

Glossary

| | |
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| ALMP | Active labour market policies |
| AWG | Ageing working group |
| CDS | Credit default swap |
| CEECs | Central and East European countries |
| CPO | Competition Protection Office |
| ECB | European Central Bank |
| EIUA | Employment and Insurance against Unemployment Act |
| EMU | European Monetary Union |
| EPL | Employment protection legislation |
| ERA | Employment Relationships Act |
| ERM | Exchange rate mechanism |
| EU | European Union |
| EU15 | EU members before enlargement in May 2004 |
| EU27 | EU members as from 2007 |
| EUR | Euro |
| FDI | Foreign direct investment |
| GDP | Gross domestic product |
| HSE | Slovenian Power Holding Limited |
| ICT | Information and communication technology |
| IFRS | International financial reporting standards |
| IMAD | Institute for Macroeconomic Analysis and Development |
| IMF | International Monetary Fund |
| KAD | Capital Fund |
| MBO | Management buyouts |
| NAIRU | Non-accelerating inflation rate of unemployment |
| NDC | Notional defined contribution |
| NKBM | Nova Kreditna Banka Maribor |
| NLB | Nova Ljubljanska Banka |
| NMS | New member states |
| NPL | Non-performing loan |
| NRDP | National Research and Development Programme |
| PAEFI | Public Agency for Entrepreneurship and Foreign Investment |
| PDIA | Pension and Disability Insurance Act |
| PLYA | Project learning for young adults |
| PMR | Product market regulation |
| R&D | Research and Development |
| SID | Export and development bank |
| SME | Small and medium-sized enterprises |

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| SOD | Compensation of Restitution Fund |
| TIA | Slovenian Technology Agency |
| TFP | Total factor productivity |
| USD | United States dollar |
| VAT | Value added tax |
| ZPIZ | Institute of Pension and Invalidation Insurance |

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On 16 May 2007, the OECD Council decided to open discussions with Slovenia on accession to the Organisation and, on 30 November 2007, an Accession Roadmap, setting out the terms, conditions and process for accession was adopted [C(2007)104/FINAL].

In the Roadmap, the OECD Council requested a number of OECD Committees to provide it with a formal opinion. The Economic and Development Review Committee was requested to review Slovenia's overall economic policies in order to provide a formal opinion on the degree of coherence of Slovenia's policies with those of OECD member countries. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council will decide whether to invite Slovenia to become a member of the Organisation.

The present Economic Survey of Slovenia was prepared for the purposes of the accession review of Slovenia and was discussed by the Economic and Development Review Committee on 16 April 2009. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 May 2009.

The Secretariat's draft report was prepared for the Committee by Colin Forthun, Isabell Koske, Willi Leibfritz, Axel Mittelstadt and Margit Molnar under the supervision of Pierre Beynet. Research assistance was provided by Desney Erb.

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This book has...

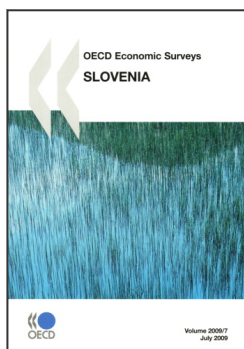


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