# OECD Economic Surveys
# SLOVENIA

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# OECD Economic Surveys: Slovenia 2013

BETTER POLICIES FOR BETTER LIVES

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

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

*The Secretariat's draft report was prepared for the Committee by Rafał Kierzenkowski and Olena Havrylchyk under the supervision of Pierre Beynet. Research assistance was provided by Desney Erb. The* Survey *also benefited from external consultancy work.*

*The previous* Survey *of Slovenia was issued in February 2011.*

## BASIC STATISTICS OF SLOVENIA, 2011

(Numbers in parentheses refer to the OECD average)[a]

### LAND, PEOPLE AND ELECTORAL CYCLE

| | | | | | |
|---|---|---|---|---|---|
| Population (million) | 2.0 | | Population density per km² | 100.4 | (34.3) |
| Under 15 (%) | 14.0 | (18.4) | Life expectancy (years, 2010) | 79.5 | (79.7) |
| Over 65 (%) | 16.7 | (14.9) | Men | 76.3 | (76.9) |
| Foreign-born (%, 2010) | 11.2 | | Women | 82.7 | (82.5) |
| Latest 5-year average growth (%) | 0.3 | (0.5) | Last general election | December 2011 | |

### ECONOMY

| | | | | | |
|---|---|---|---|---|---|
| Gross domestic product (GDP) | | | Value added shares (%) | | |
| In current prices (billion USD, 2012) | 45.6 | | Primary | 2.6 | (2.5) |
| In current prices (billion EUR, 2012) | 35.5 | | Industry including construction | 30.5 | (27.8) |
| Latest 5-year average real growth (%) | -1.1 | (0.8) | Services | 66.9 | (69.4) |
| Per capita, PPP (thousand USD) | 27.6 | (35.4) | | | |

### GENERAL GOVERNMENT

Per cent of GDP

| | | | | | |
|---|---|---|---|---|---|
| Expenditure | 50.7 | (43.6) | Gross financial debt[b] | 52.1 | (98.5) |
| Revenue | 44.3 | (36.9) | Net financial debt[b] | 3.7 | (59.8) |

### EXTERNAL ACCOUNTS

| | | | | | |
|---|---|---|---|---|---|
| Exchange rate (USD per EUR, 2012) | 1.286 | | Main exports (% of total merchandise exports) | | |
| PPP exchange rate (USA = 1, 2012) | 0.643 | | Machinery and transport equipment | 36.6 | |
| In per cent of GDP | | | Manufactured goods | 23.0 | |
| Exports of goods and services (2012)[c] | 75.0 | (52.7) | Chemicals and related products, n.e.s. | 16.5 | |
| Imports of goods and services (2012)[c] | 71.0 | (49.7) | Main imports (% of total merchandise imports) | | |
| Current account balance | 0.0 | (-0.7) | Machinery and transport equipment | 28.3 | |
| Net international investment position | -39.3 | | Manufactured goods | 19.2 | |
| | | | Mineral fuels, lubricants and related materials | 15.2 | |

### LABOUR MARKET, SKILLS AND INNOVATION

| | | | | | |
|---|---|---|---|---|---|
| Employment rate (%) for 15-64 year olds (2012)[c] | 64.1 | (64.8) | Unemployment rate (%) | | |
| Men | 67.4 | (73.0) | Total (age 15+, 2012)[c] | 8.8 | (7.9) |
| Women | 60.5 | (56.8) | Youth (age 15-24, 2012)[c] | 20.5 | (16.2) |
| Average hours worked per year | 1 662 | (1 776) | Long-term (> 1 year) unemployed | 3.6 | (2.6) |
| Gross domestic expenditure on R&D (% of GDP)[b] | 2.5 | (2.4) | Tertiary educational attainment 25-64 year-olds (%, 2010) | 23.7 | (30.7) |

### ENVIRONMENT

| | | | | | |
|---|---|---|---|---|---|
| Total primary energy supply per capita (toe) | 3.6 | (4.3) | $CO_2$ emissions from fuel combustion per capita (tonnes, 2010) | 7.5 | (10.1) |
| Renewables (%) | 13.4 | (8.2) | Water abstractions per capita (1 000 $m^3$, 2010) | 0.5 | |
| Fine particulate matter concentration (urban, PM10, µg/$m^3$, 2008) | 29.0 | (22.0) | Municipal waste per capita (tonnes)[d] | 0.4 | (0.5) |

### SOCIETY

| | | | | | |
|---|---|---|---|---|---|
| Income inequality (Gini coefficient, late 2000s) | 0.236 | (0.314) | Education outcomes (PISA score, 2009) | | |
| Relative poverty rate (%, late 2000s) | 13.2 | (17.7) | Reading | 483 | (493) |
| Public and private spending (% of GDP) | | | Mathematics | 501 | (496) |
| Health care (2010) | 9.0 | (9.7) | Science | 512 | (501) |
| Pensions (2009) | 10.9 | (8.2) | Share of women in parliament (%, February 2013) | 24.6 | (25.3) |
| Education (primary, secondary, post sec. non tertiary, 2009) | 4.0 | (4.0) | Net official development assistance (% of GNI) | 0.1 | (0.4) |

Better life index: *www.oecdbetterlifeindex.org*

*a)* Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exists for at least 29 member countries.

*b)* 2010 for the OECD.

*c)* 2011 for the OECD.

*d)* 2009 for the OECD.

*Source:* Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

# Executive summary

## Main findings

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

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

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

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

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

## Key recommendations

### *Solving the banking crisis*

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

### *Strengthening fiscal sustainability*

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

### *Boosting potential growth through structural reforms*

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

# Assessment and recommendations

## The economy is in a deep recession

### *Stabilising the economy is a key policy challenge*

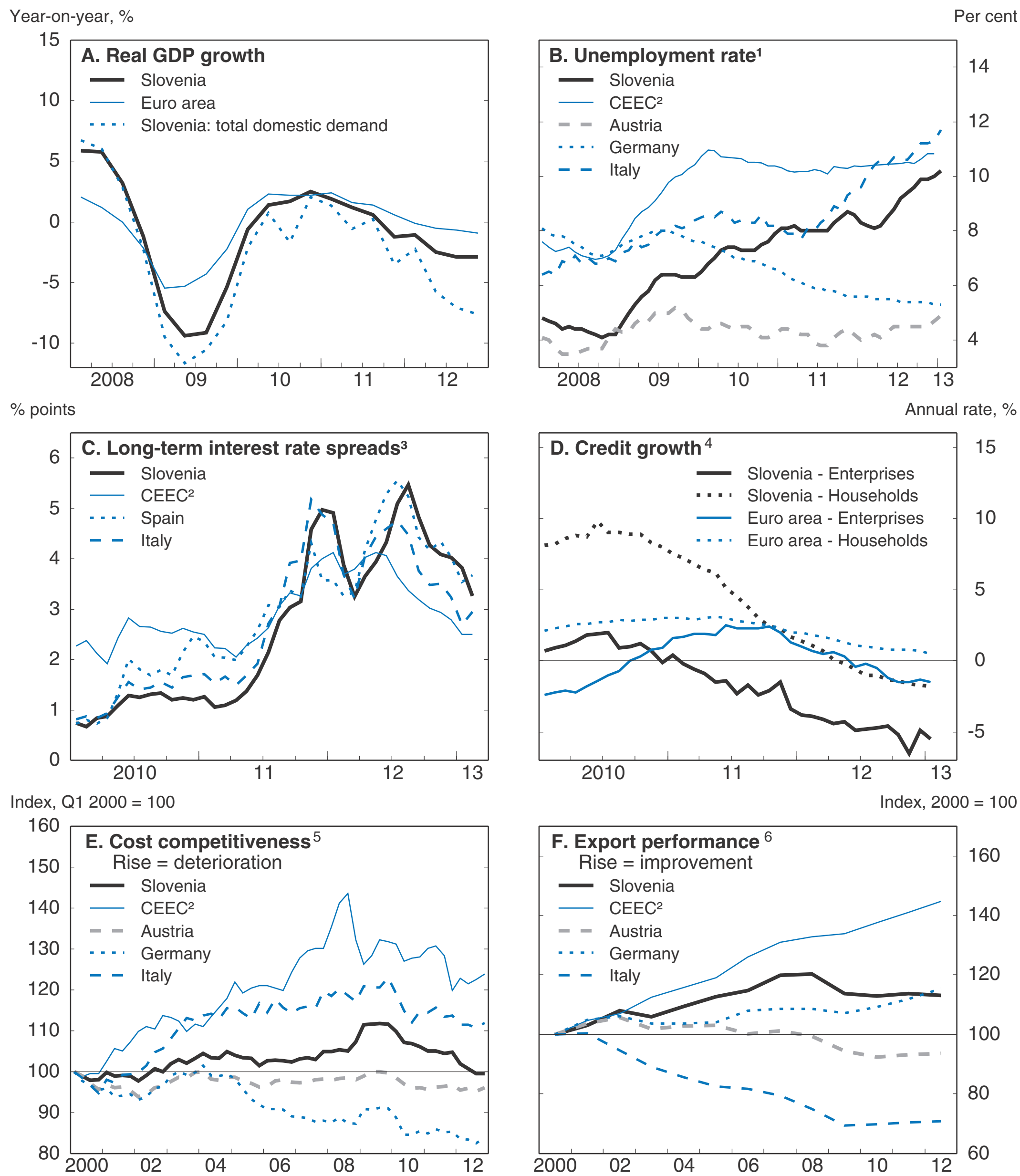
Slovenia has entered a double-dip recession and faces growing unemployment and heightened financial market stress (Figure 1, Panels A, B and C). The pre-crisis boom, driven by easy access to external funding and excessive risk taking by banks and businesses, has led to a protracted bust, which is compounded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

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

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

To make reforms happen, social and political consensus is needed. The political economy of reform remains difficult, notably because it has been easy to use a referendum

Figure 1. **Key macroeconomic developments**




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

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

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to veto a law. The ongoing discussion in Slovenia on ways to introduce stricter criteria on the use of referendums is hence welcome. Options currently envisaged are to tighten the conditions for calling a referendum, to impose a minimum turnout, and to exclude some laws, such as tax and budget implementation laws.

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

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

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

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

Table 1. **Recent trends and outlook**

Percentage change, volume

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

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

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

borrowing costs. Higher than expected bank recapitalisation needs could also trigger widening spreads. On the upside, a reduction of market concerns on the euro area debt crisis would support recovery.

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

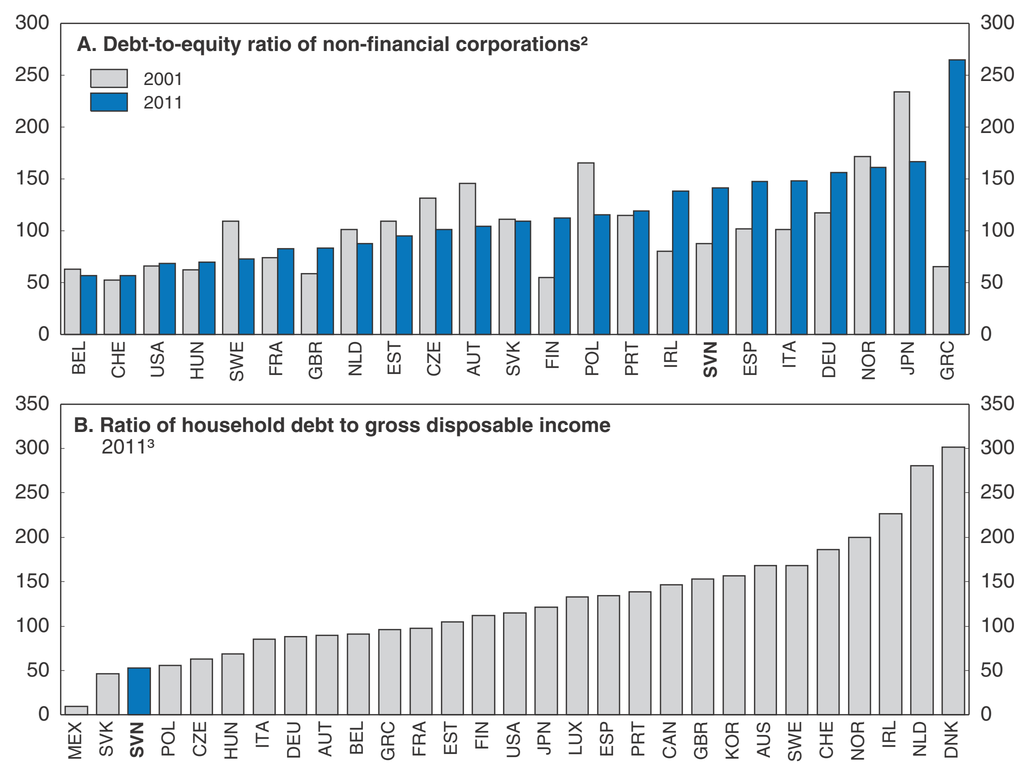
## Restoring the banking sector is the most urgent priority

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

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

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

Per cent




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

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

StatLink http://dx.doi.org/10.1787/888932796777

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

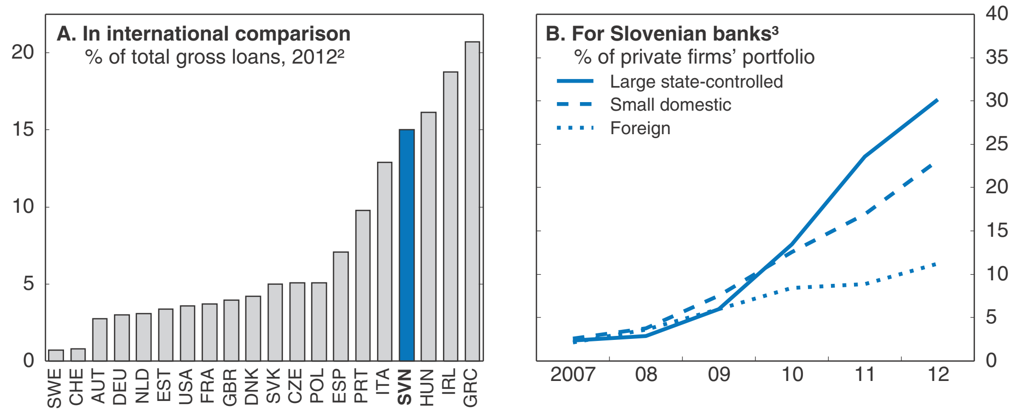
Anecdotal evidence also indicates mismanagement of the SOBs. As an example of credit misallocation, the two largest SOBs – Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) – extended loans amounting to, respectively, 20% and 15% of their capital to Zvon Ena, a financial holding company,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

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

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

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

Share of non-performing loans, per cent




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

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

StatLink http://dx.doi.org/10.1787/888932796796

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

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

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

Figure 4. **Capital adequacy ratios**

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


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

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

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(about one fifth of GDP) and if such loans were to be fully written off, they would most likely result in large bank capital shortfalls.

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

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

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

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

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

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

### *Deleveraging banks and the corporate sector*

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

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

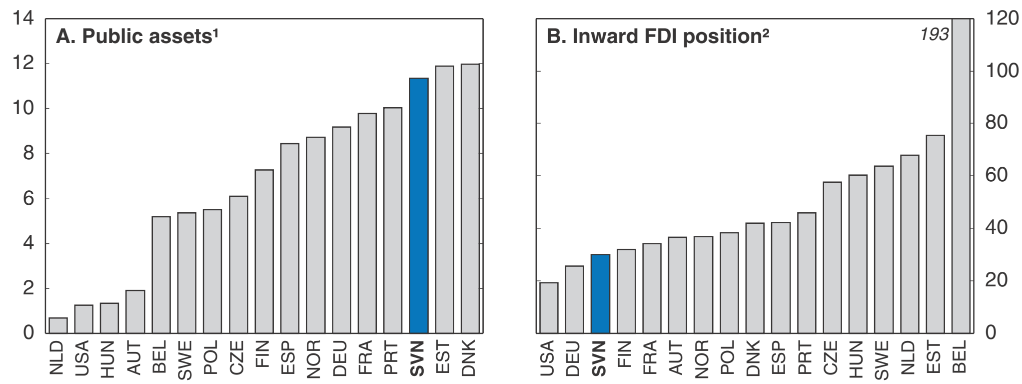
Long in-court insolvency procedures in Slovenia reduce recovery rates. According to the World Bank 2012 *Doing Business* indicators, it takes on average 24 months in Slovenia to complete a standard bankruptcy procedure (involving a main secured creditor and several unsecured ones). By contrast, it is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

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

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

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

Per cent of GDP, 2011




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

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

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### *Enhancing bank supervision*

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

The provisioning in Slovenia is done in accordance with International Accounting Standards, which gives the banks the discretion to apply different provisioning methods that are not always comparable. Given banks' poor risk practices in the past, they should instead be required to apply a homogeneous methodology for provisioning. The Bank of Slovenia should develop on-site examinations of loan portfolios on larger samples and induce banks to take a more conservative stance on collateral valuations (IMF, 2012b). Taking into account the difficulty of improving banks' risk practices and corporate governance, the Bank of Slovenia should be more conservative and proactive in its provisioning requirements and ensure that other remedial actions are taken in a timely manner. Given the small size of the Slovenian economy and tight interlinkages between banks and firms, it has to be particularly prudent with provisioning requirements for large and related exposures.

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

Box 1. **Core recommendations to shore up the banking sector**

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

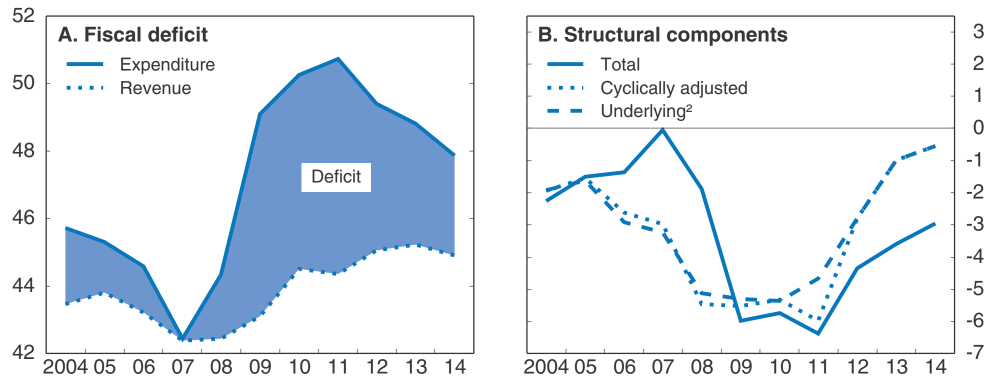
## Restoring public finances

### *Fiscal consolidation has been difficult*

The budget deficit rose significantly during the downturn (Figure 6, Panel A) and gross public debt reached 47% of GDP in 2011, up from only about 20% at the outset of the global crisis. The debt ratio may rise to around 72% of GDP in 2013, when considering the official maximum estimation of debt issuance of the BAMC to take over impaired loans (11% of GDP) and the cost of equity injections in banks of 3% of GDP. Long-term fiscal sustainability

Figure 6. **Fiscal deficit and its structural components**

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




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

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

StatLink http://dx.doi.org/10.1787/888932796853

is weak and gross public debt is projected to reach 87% of GDP in 2025 in a no-policy-change scenario (European Commission, 2012a) and could exceed 100% of GDP by 2025 when including the already anticipated costs of rescuing banks. The materialisation of a number of risks could push the public debt even more in the short term: if growth turns out to be weaker than expected; if banks' recapitalisation exceeds official estimates; or if some contingent liabilities are recognised (IMF, 2012b), such as a possible reclassification of the debt of the national highway company (DARS) into general government, which would increase public debt by about 8-9% of GDP. Moreover, Slovenia faces a significant rise in total age-related public expenditure (which includes pensions, health and long-term care) by about 10 percentage points of GDP over the years 2010-60, against around 3 percentage points of GDP for the EU average (European Commission, 2012b). While the recent pension reform has been a step in the right direction, the expenditure on pensions is still expected to increase by 5 to 6 percentage points of GDP between 2020 and 2060 (see below).

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

### *Improving the quality of fiscal consolidation*

While the consolidation path is ambitious, policy decisions have relied too heavily on temporary measures, across-the-board cuts in the public wage bill and reductions in discretionary expenditure, including on tertiary education (see Box 2). On the spending side, more durable savings could be made by rationalising welfare expenditure (see below). Many SOEs other than SOBs are also unprofitable, in particular in the transport sector (railway and airline companies), and require regular bailouts. Any further recapitalisations

### Box 2. **Fiscal consolidation programmes since 2010**

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

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

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

of SOEs should go in tandem with a hardening of their budget constraints through the adoption of well-defined restructuring programmes. Reorganising local governments by reversing the trend of municipal fragmentation could also help to rationalise public expenditure (OECD, 2011c).

Certain measures on the revenue side should be reviewed also. The authorities have started lowering the corporate income tax rate by one percentage point per year, from 20% in 2011 to 15% by 2015. While such cuts would support investment in the medium term, subdued demand and evidence of excess capacity suggest that they may fail to revive growth in the short term. To ensure needed fiscal consolidation, further cuts should be delayed or the authorities should ensure that they are offset fully by other measures. Generous research and development (R&D) and investment tax allowances have also been adopted to boost growth. They apply to the level of R&D spending, not its increment, which may induce deadweight costs for expenditure that would have been made anyway. Public grants might be more cost-efficient and more effective in generating new spending, though they may imply winner-picking and are already well developed in Slovenia (OECD, 2012a). Beyond the adoption of an exceptional recurrent tax on high-value immovable property not used for business activities, a structural overhaul and hike in such taxes for all properties, as planned in 2011, would also be a step in the right direction. Indeed, recurrent taxes on residential property are among the least damaging to growth (Arnold et al., 2011; European Commission, 2012b), but are low in Slovenia.

### *Strengthening the fiscal framework*

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

Slovenia has to follow the requirements set up in the European Union Treaty for Stability, Convergence and Governance which requires a path towards a balanced structural budget. The government plan to introduce a balanced budget rule in the Constitution has not been realised. Nevertheless, the authorities should improve the fiscal rule adopted in mid-2009. The rule links public expenditure to potential output growth and includes a correction for deviations of public debt and budget deficits from targets. Yet it has been insufficiently used to guide fiscal policy as its parameters have been frequently revised (Court of Audit, 2012; European Commission, 2012c). The 2011 *Economic Survey* identified ways to improve the rule and reinforce its credibility (OECD, 2011b). In particular, the fiscal targets and the parameters underlying the convergence speed to these targets should be made more transparent. The rule should be supported by well-defined escape clauses and the fiscal council should be charged with assessing the rationale for their use. The rule could also be complemented by an adjustment account, similar to the Swiss debt brake rule.

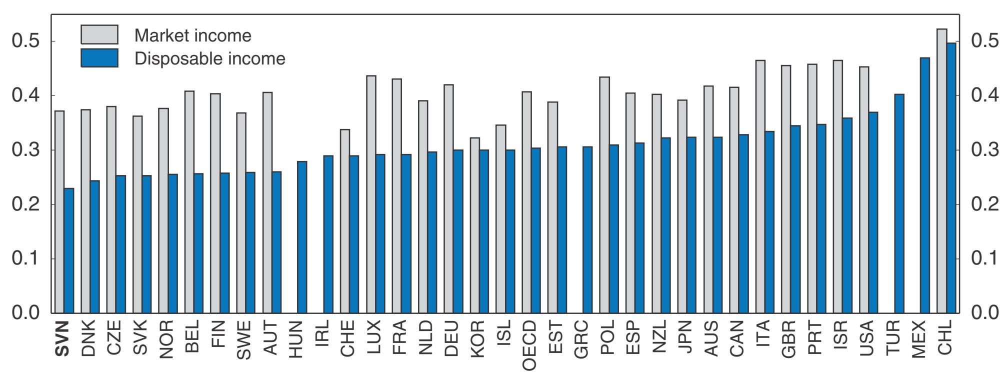
### *Restructuring welfare spending*

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

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

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

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




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

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

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

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

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

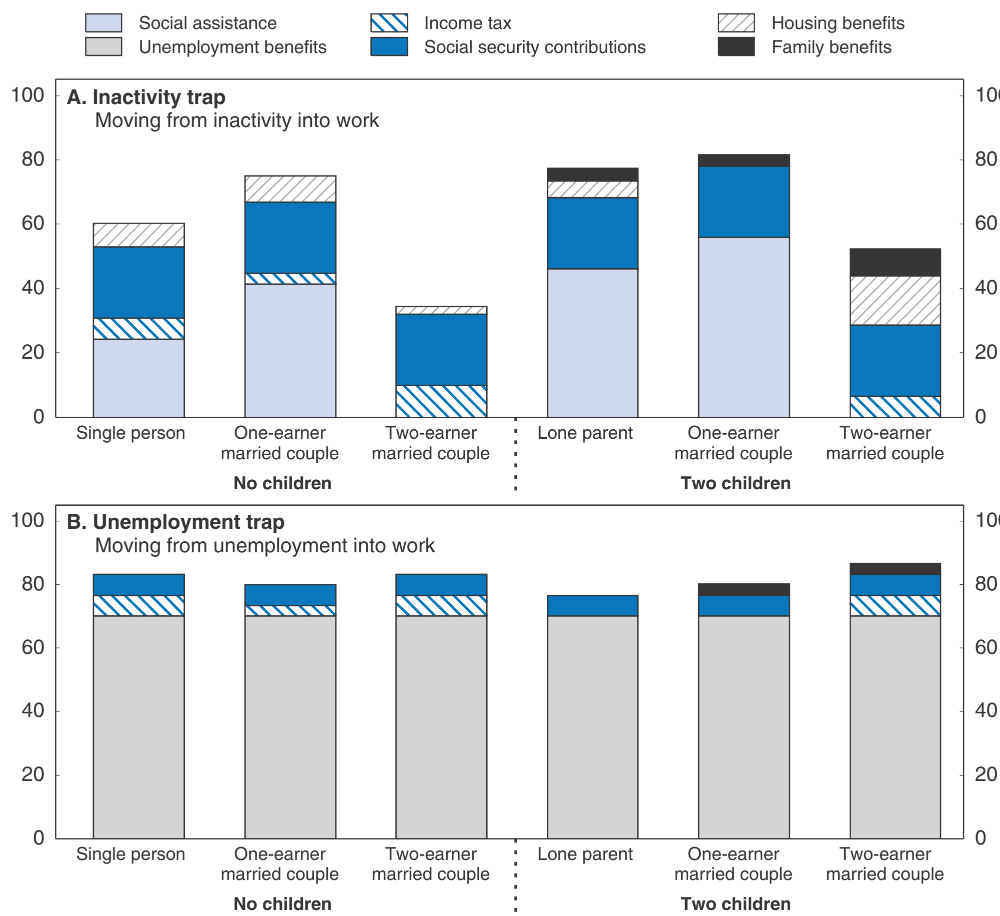
In-kind benefits contribute to diminishing income inequality in Slovenia (OECD, 2011d). In particular, the income-increasing effect of early childhood education and care services is large for families with young children and social housing is highly targeted to the poorest individuals. However, the allocation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

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

Despite relatively good educational outcomes and the education system's capacity to equip the labour force with relevant skills, there is some scope to obtain a more efficient use of public resources, as discussed in the education chapter of the 2011 *Economic Survey* (OECD, 2011b). Increasing pupil-teacher ratios in early childhood and lower secondary education and class sizes in primary and lower secondary education could lead to a merger

Figure 8. **Inactivity and unemployment traps are large**

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




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

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

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

StatLink http://dx.doi.org/10.1787/888932796891

of some schools and school districts in cities as well as linking schools into clusters. Overall, this would allow a more effective use of staff, but could also increase population density in some areas. The authorities considered increasing teaching obligations and setting up unified school districts along with the adoption of a floor for the minimum number of pupils in a classroom. This could have led to lower costs due to a merger of some school districts and, as a result, more homogenous distribution of pupils among schools and higher class occupancy rates. Yet, the reform proposals have met with strong opposition from teachers' trade unions and the planned reorganisation steps have been suspended of late.

### *Reforming the financing of health care*

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

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

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

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

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

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

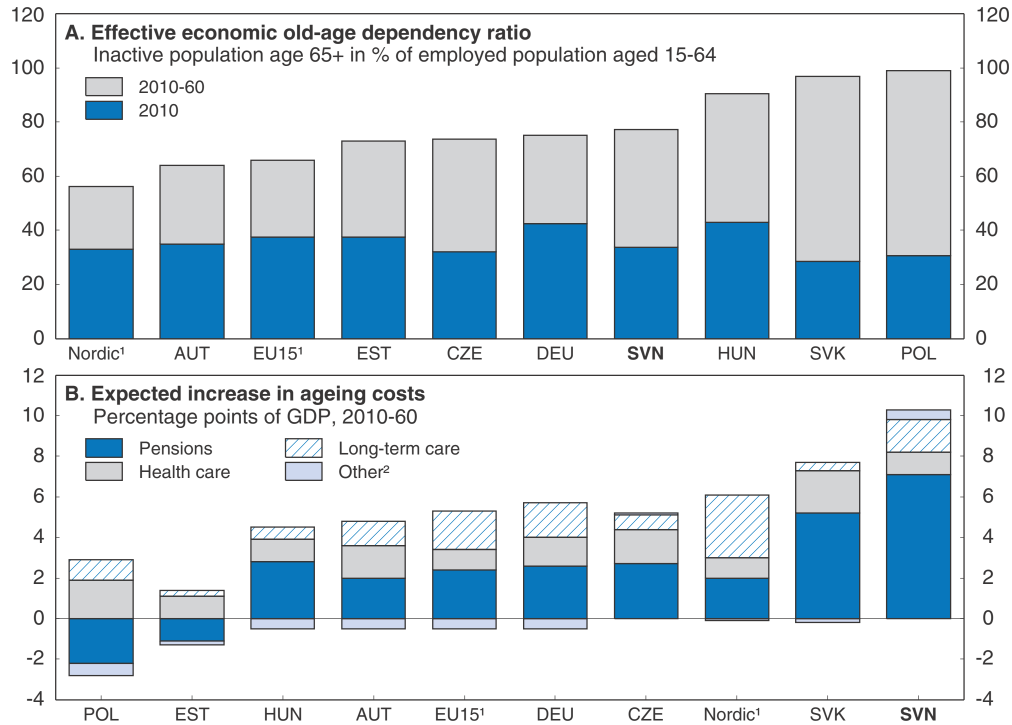
Box 3. **Core recommendations to pursue fiscal consolidation**

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

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

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

Figure 9. **Challenges related to population ageing are immense**




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

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

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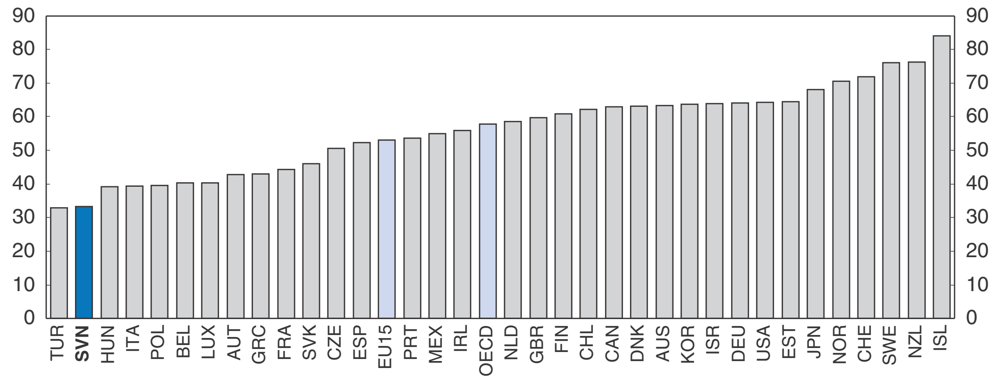
### *Reforming pensions*

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

The low effective retirement age, which now contributes to one of the lowest labour participation of older workers in the OECD (Figure 10), would be increased if the pension eligibility age (both statutory and minimum) were raised further and contributory periods made longer. Eventually, pensionable ages should be linked to life expectancy. Penalties

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

Per cent, age 55-64, 2011




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

StatLink http://dx.doi.org/10.1787/888932796929

(bonuses) for early (deferred) retirement are still too low to encourage longer activity. Finally, numerous special pension regimes (policemen, firemen, pilots, miners, etc.) offer generous early retirement provisions, which should also be tightened.

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

### *Developing long-term care*

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

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

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

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

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

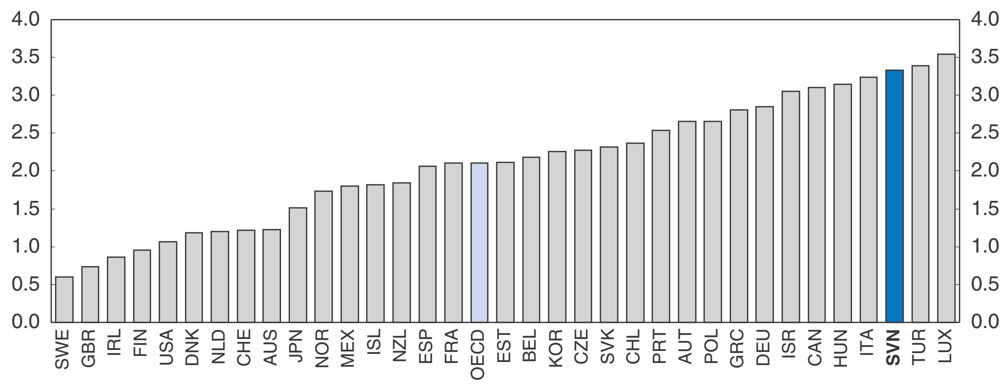
### *Enhancing product market competition*

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

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

Figure 11. **Product market regulation in professional services**

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




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

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

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

### *Strengthening safety nets*

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

### *Reducing labour market segmentation*

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

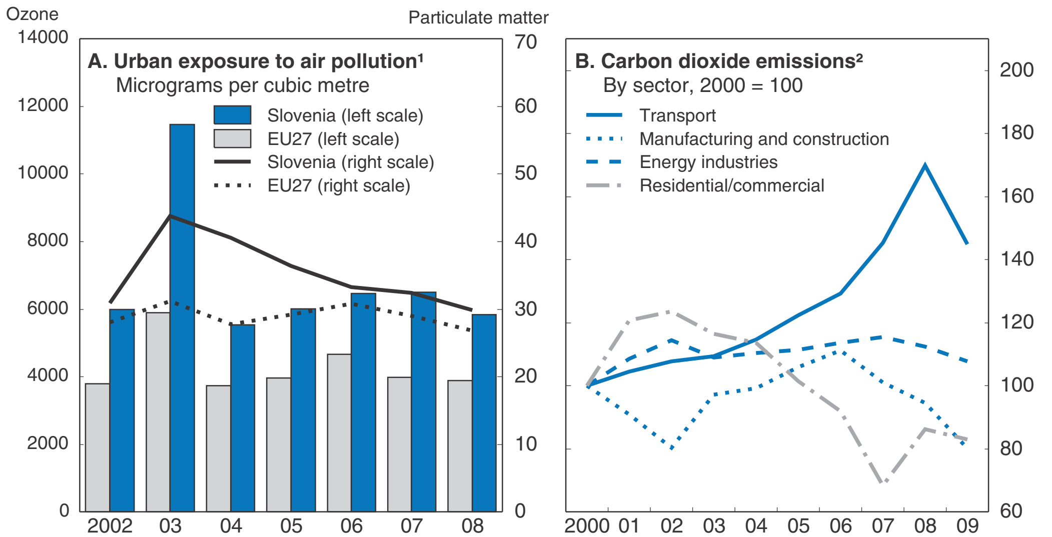
The recently adopted measures reduce the protection of regular employment by alleviating cumbersome administrative procedures and conditions for dismissals, including easier notification procedures, shorter notice periods, and reduced severance payments; the conditions under which dismissals are unfair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

### *Making growth more environementally friendly*

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

Slovenia's extraordinarily rich biodiversity and landscapes continue to be affected by habitat loss and fragmentation due to urbanisation, the development of transport infrastructure and intensive agriculture. More progress is needed to strengthen integration of environmental considerations in economic and structural policies. Slovenia raises a comparatively large amount of environmentally related taxes, which were around 3% of GDP in 2010, the fifth highest share in the OECD. However, as in many other countries, the

Figure 12. **Air pollution indicators**




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

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

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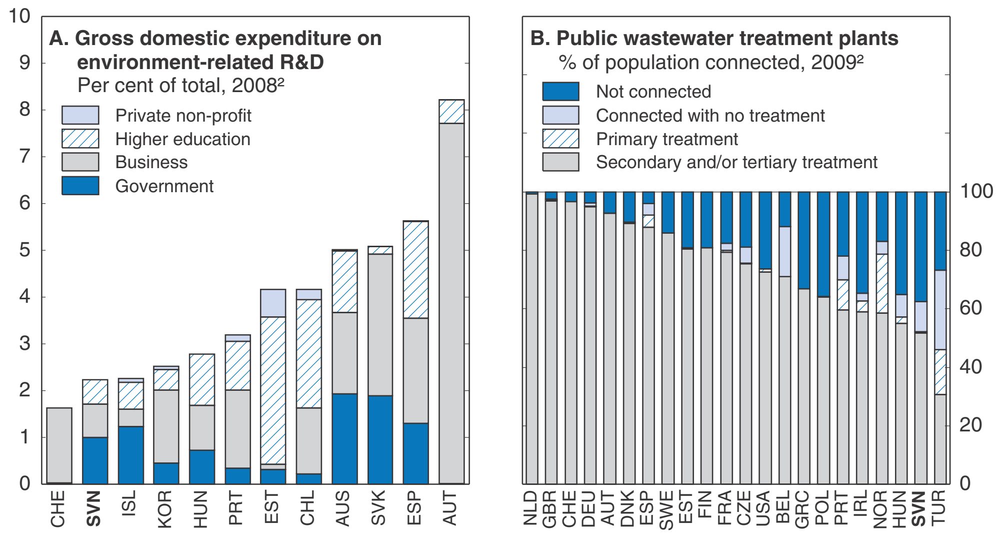
largest share of environmentally related taxes is accounted for by fuel taxes. While overall effective tax rates on energy are generally at or above the OECD average level (albeit transport fuel rates are at the lower end among other European OECD countries), high rates of fuel consumption growth, partly associated with transit traffic, have made for relatively high revenue (OECD, 2013a).

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

Green innovation and its dissemination represent a fairly unexploited source of green growth (OECD, 2012c). In spite of recently increased spending on environment-related R&D (Figure 13, Panel A), the link between public and business sector has to be strengthened to apply research outcomes to commercially viable solutions. Recently created Centres of Excellence and Centres of Competencies are a good instrument to stimulate collaboration

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




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

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

StatLink http://dx.doi.org/10.1787/888932796986

of public research organisations with the business sector. Research vouchers introduced to encourage companies to hire public research organisations are also the right step forward, which could tap more effectively on EU funds. Boosting municipal/household wastewater treatment, which is less widespread than in other countries (Figure 13, Panel B) is also needed. While building new treatment plants could require important resources, a cost-effective option in some cases would be to build artificial wetlands to treat domestic sewage and industrial wastewater (OECD, 2012c).

Box 5. **Core recommendations for sustainable growth**

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

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# ANNEX A1

## *Progress in structural reform*

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

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

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

*Chapter 1*

# Banks' restructuring and smooth deleveraging of the private sector

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

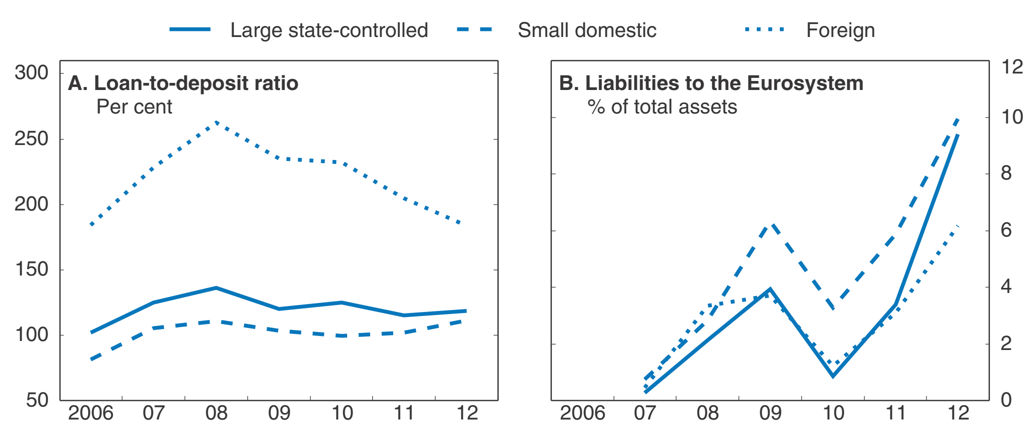
## Poor corporate governance led to a major banking crisis

### *A boom-bust credit cycle led to an over-indebted corporate sector and high impaired loans*

In the run up to the crisis, the loan-to-GDP ratio of Slovenian banks more than doubled from around 40% of gross domestic product (GDP) in 2003 to close to 90% in 2008. This increase reflected a combination of low interest rates and a massive inflow of foreign funding, which reached more than 30% of banks' liabilities and boosted the loan-to-deposit ratio, which peaked at 160% in mid-2008. Not all banks were exposed in the same manner: in 2008, the loan-to-deposit ratio was at 140% for large state-controlled banks, 110% for small domestic banks and 260% for foreign banks (Figure 1.1, Panel A). As the crisis has unveiled, the loan-to-deposit ratios have declined substantially to an average of 136% (October 2012) and currently only foreign banks exhibit high ratios (180% in October 2012). By contrast, the loan-to-GDP ratio has kept increasing up to 92% in 2011 due to the collapse of GDP. Instead of cross-border loans, banks have resorted to funding from the Eurosystem (Figure 1.1, Panel B). In October 2012, the share of Eurosystem liabilities reached 8% of total assets due to the use of different unconventional instruments by the European Central Bank (ECB), such as fixed rate full allotment and long-term refinancing operations of different maturities.

Figure 1.1. **Funding of banks in Slovenia**[1]

End of year[2]




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

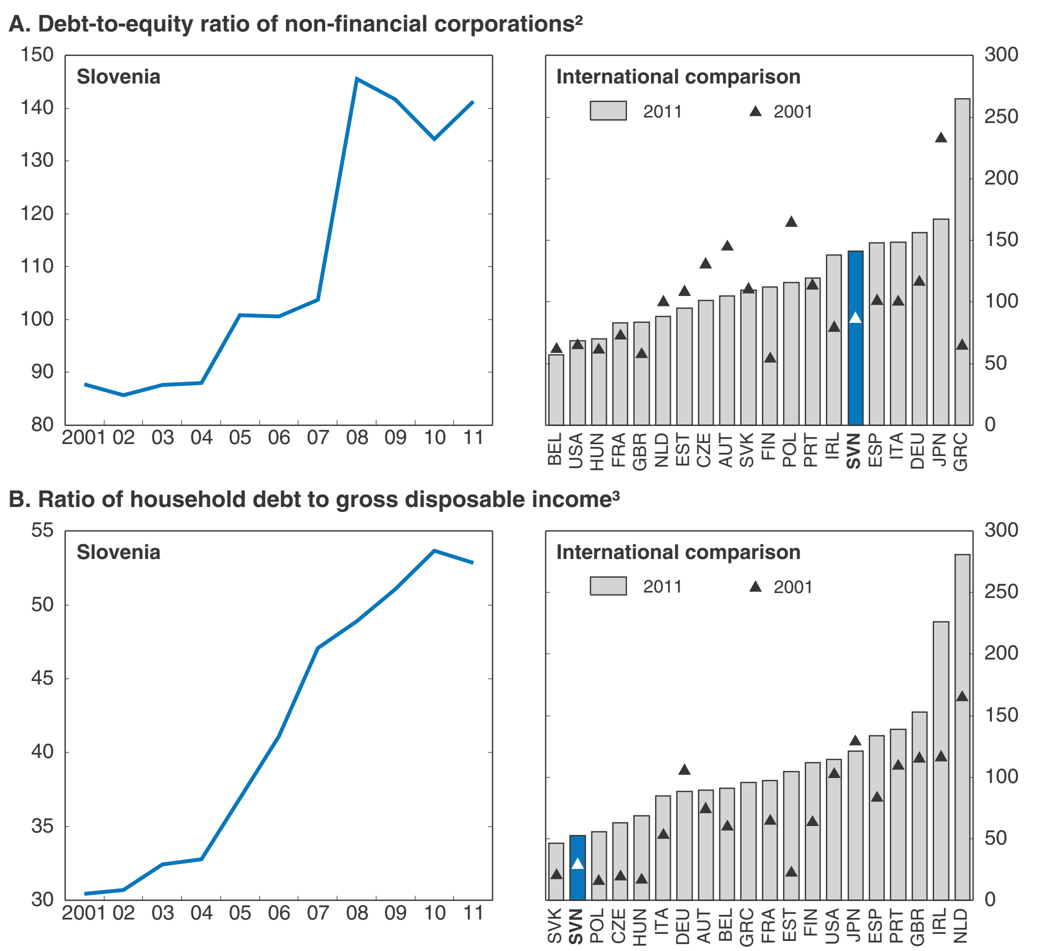
*Source:* Bank of Slovenia.

StatLink http://dx.doi.org/10.1787/888932797005

Fuelled by banking loans, the leverage of Slovenian non-financial corporations has increased. Although the current level of the debt-to-GDP ratio, at close to 141%, is slightly above the OECD average, there are a number of risks that point to its unsustainability. The largest risk is related to the weak corporate governance of state-owned banks (SOBs), which is discussed below. Another risk is that the amount of equity is very low and, thus, leverage is high. The debt-to-equity ratio rose by around 60 percentage points between 2001 and 2008, one of the largest increases in the OECD, and it still stands at 143% in 2011 (Figure 1.2, Panel A). Construction and real estate sectors are the most indebted as their debt-to-equity ratios exceed 315%. The high debt-to-equity ratios are in sharp contrast to other transition countries, such as Hungary or Estonia, where debt-to-equity ratios have remained stable despite the explosion of debt relative to GDP. The poor situation in Slovenia reflects substantial difficulties of companies in raising equity due to shallow local

Figure 1.2. **Household and corporate leverage**[1]

Per cent




1. The debt used in the calculations is the sum of the following liability categories, whenever available/applicable: currency and deposits, securities other than shares (except financial derivatives), loans, insurance technical reserves and other accounts payable.
2. Debt as a percentage of shares and other equity. Data for 2010 instead of 2011 for Estonia and Japan.
3. Data for 2002 instead of 2001 for Ireland; 2010 instead of 2011 for Estonia, Japan and Poland.

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

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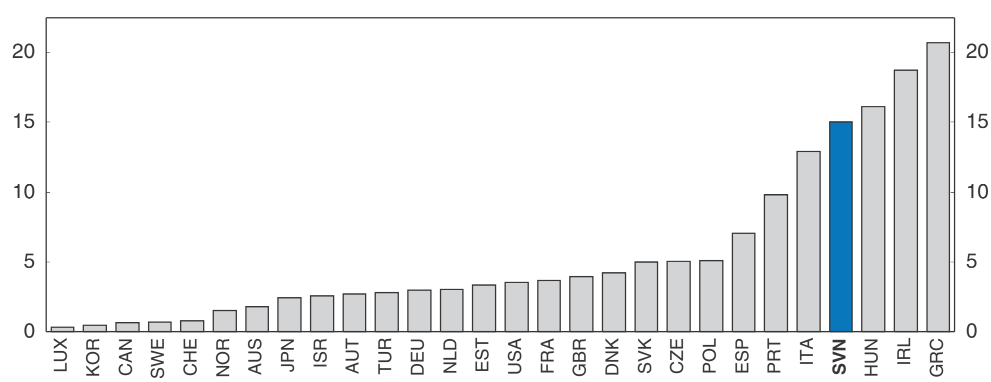
capital markets and limited foreign direct investment. In the medium term, the necessary deleveraging should be achieved not only by reducing the debt, but also by raising new equity.

By contrast, household indebtedness is low (Figure 1.2, Panel B). Despite house price overheating in some parts of the country, relatively prudent lending in general (loan-to-value ratios peaked at around 60% in 2007 and declined to 54% in 2012) has protected households from a major deterioration of their balance sheets. Nevertheless, a further deterioration of the labour market is likely to put pressure on repayment capabilities and there are a number of risks that can materialise in the future. Real estate prices fell by 12% between end 2007 and the third quarter of 2012, but many market participants expect them to decline further: the number of transactions has dropped by 45% between the end of 2007 and the third quarter of 2012. Another risk is related to the 17% of housing loans that are denominated in Swiss francs (December 2012): the steep appreciation of the Swiss franc since 2008 has increased the repayment burden for these borrowers, but the ceiling on the exchange rate introduced by the Swiss Central Bank in September 2011 has prevented further deterioration.

The unwinding of the boom has led to a high proportion of non-performing loans (NPLs), defined as all classified claims to clients in arrears over 90 days. NPLs jumped to 14% of the credit portfolio (19% of GDP) in October 2012, one of the highest ratios in the OECD (Figure 1.3). As the recession drags on, this is likely to deteriorate further. When considering all claims in arrears (i.e. even those that are in arrears by less than 90 days), they represent 21% of the credit portfolio or 28% of GDP. The situation is particularly worrying in the non-financial corporate sector where claims to clients in arrears for more than 90 days reached 24% in October 2012. Construction companies are responsible for a large share, as 62% of their claims are overdue for more than 90 days and the largest companies are insolvent (Figure 1.4). NPLs are also high (36% of the credit portfolio) in the financial intermediation sector that mostly includes financial holding companies that

Figure 1.3. **Non-performing loans are very high**[1]

Non-performing loans in per cent of total gross loans, 2012[2]




1. Overdue or non-performing loans are loans (claims in the case of Slovenia) with failed payment obligations for at least 90 days.
2. Latest quarter based on available bank balance sheet data; third quarter of 2012 for the majority of countries shown.

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

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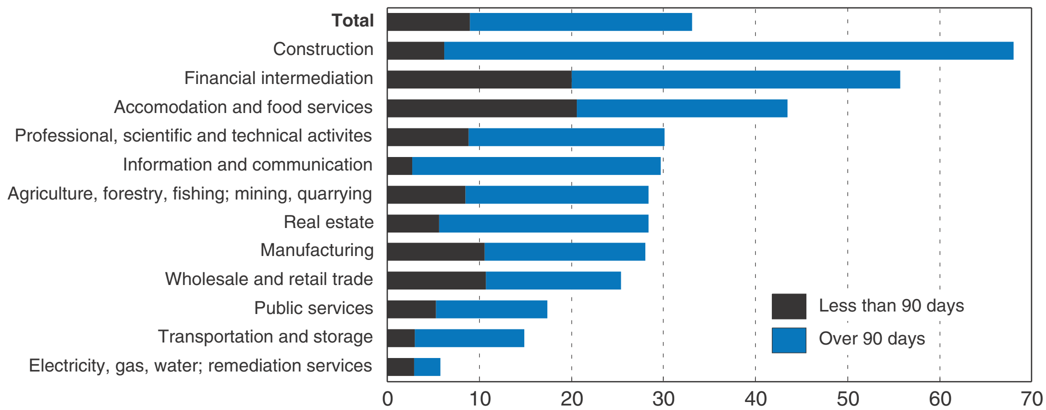
Figure 1.4. **Loans in arrears in different economic sectors**

Per cent of total loans, November 2012




*Source:* Bank of Slovenia (2013), "Poslovanje bank v tekočem letu, gibanja na kapitalskem trgu in obrestne mere", February.

StatLink http://dx.doi.org/10.1787/888932797062

were used for privatisation through leveraged buy-outs. In contrast, the share of clams in arrears for households is much smaller, at 4% of total household loans.

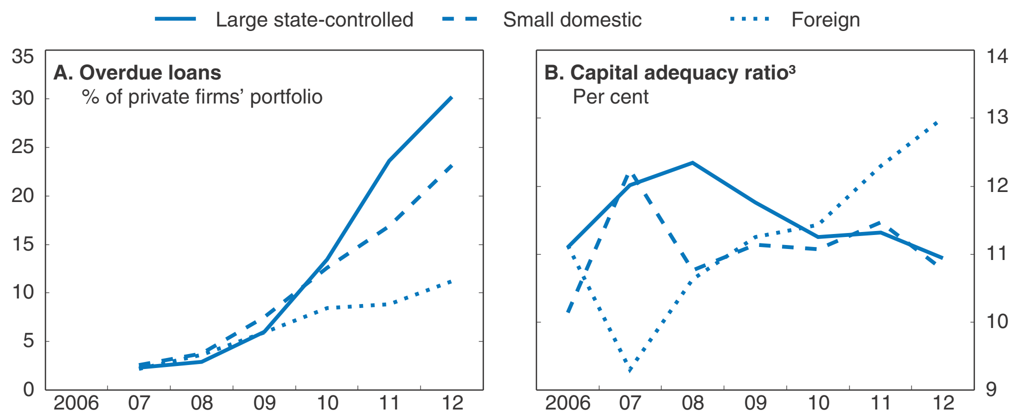
The high level of NPLs is explained by the fact that banks accumulate bad loans and do not write them off, even when the necessary provisions are accumulated. The average monthly ratio of written-off loans to overdue loans was only 0.2% in the first nine months of 2012, and at that rate banks would require 38 years to clean up their loan portfolios. This compares poorly with other countries in the region, like Hungary and Estonia, which would require 6-7 years to completely clean their portfolios, which is already considered too long by their supervisors. Banks were unwilling to write-off their bad loans because of tax impediments, as they were uncertain if the write-offs were accounted as losses. The situation appears to be changing, as the tax authorities, at the request of the Bank of Slovenia, made it clear how the tax legislation should be implemented and thus confirmed that write-offs of bad loans can be treated as losses that decrease profits and, thus, taxes. This should affect claims classified as loss and that are fully provisioned, currently at 7% of total NPLs. Indeed, banks accelerated the cleaning up of their portfolios at the end of 2012.

### *Bank governance has a large impact on loan portfolio quality*

The bust has not affected all banks equally. The quality of the loan portfolio has deteriorated the most for large state-controlled banks that include both SOBs (i.e. banks where 50% plus one share of equity is owned by the state) and other banks controlled by the state via smaller equity stakes. For these banks, the ratio of NPLs to private corporations increased from 2% in 2007 to 30% in October 2012 (Figure 1.5). In comparison, the corresponding ratio for foreign banks amounted to 11% and for small domestic banks to 23%. This suggests that the increase in bad loans of state-controlled banks is not driven just by the business cycle. One explanation could be a wrong business model that relied on lending that was highly concentrated in the construction sector and financial holding companies. Conversely, the business model of foreign banks has been more concentrated on lending to households (Figure 1.6), who have had a lower default rate so far.

Figure 1.5. **Solvency of banks in Slovenia**[1]

End of year[2]




1. The category "large state-controlled" covers banks where the state holds, either directly or indirectly, a blocking minority shareholding. It covers the following: NLB, NKBM, Abanka, Banka Celje, SID banka and Gorenjska banka. Based on the latest data available, the share of each category of banks in terms of loans is 58% for large state-controlled, 8% for small domestic and 34% for foreign banks.
2. For 2012 the data provided is for October in Panel A and September in Panel B.
3. Total regulatory capital (Tier 1 plus Tier 2) as a per cent of risk-weighted assets.

*Source:* Bank of Slovenia.

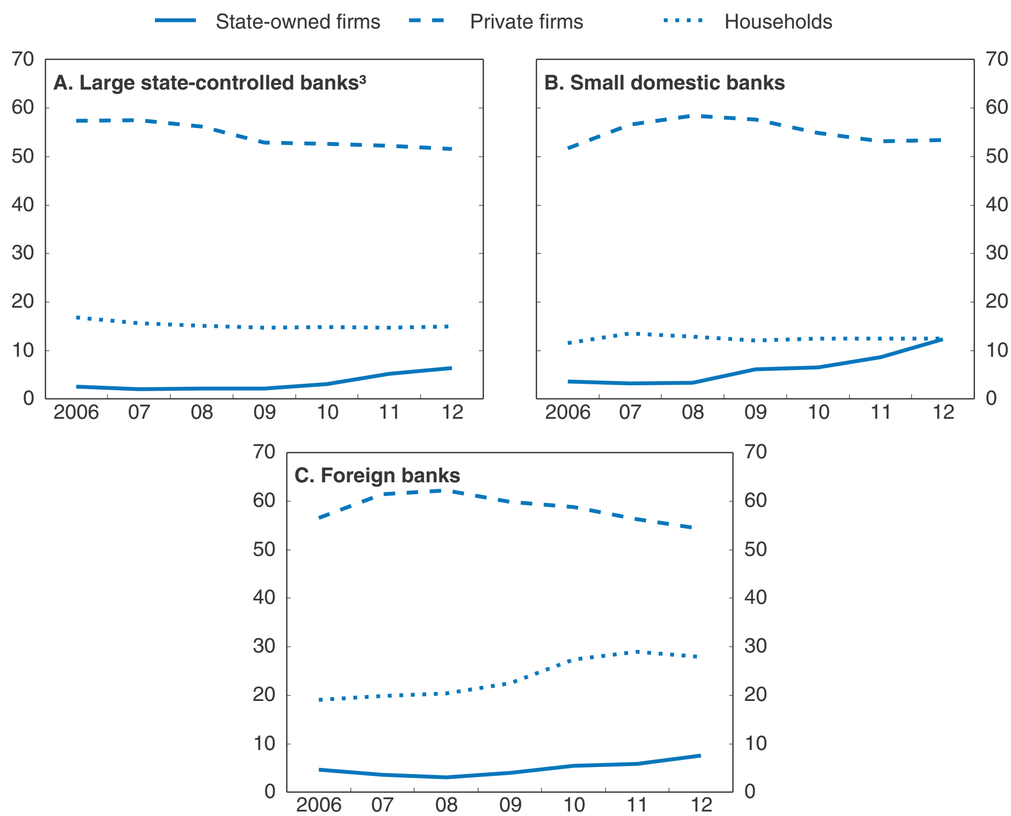
StatLink http://dx.doi.org/10.1787/888932797081

Another explanation of the higher rates of arrears of SOBs could be corporate governance problems. Academic literature documents the fact that SOBs in many countries tend to provide credit to politically connected firms (Sapienza, 2004; Khwaja and Mian, 2005). Given high rates of arrears of SOBs and the poor institutional environment, one could suspect that credit misallocation has also taken place in Slovenia. Indeed, there is a perception of favouritism in decisions of government officials and government spending is considered to be somehow wasteful: according to the 2012/13 *Global Competitiveness Report* (WEF, 2012), Slovenia is ranked 104 and 118, respectively, placing it behind China and India. When recruiting public employees (that includes managers of SOBs), political connections often matter more than merit and skills: according to the Quality of Governance survey, only Italy and Mexico fare worse among OECD countries (Dahlström et al., 2011). In the context of an extensive public ownership (state-owned assets stand at around 11% of GDP in terms of corporate valuation), notably in the banking sector (state-owned banks account for 38% of total banking loans), governance of state-owned enterprises (SOEs) appears to be weak in Slovenia (OECD, 2011a).

Anecdotal evidence suggests that the management of the SOBs has at times pursued other objectives than business ones, often under political pressure. In 2009, the chief executive officer of the Nova Ljubljanska Banka (NLB), the largest Slovenian bank, resigned after three months in office citing political interference. In 2010, his successor resigned after one year in office feeling political pressure not to sell the bank's share in Mercator (a supermarket chain), considered by the state as a company of national strategic interest. The Nova Kreditna Banka Maribor (NKBM), the second largest bank, is suspected of having extended loans to shell companies that have cost the bank EUR 60 million. Loans at excessively favourable conditions to financial holding companies have underpinned unsustainable mergers and acquisitions, management buy-outs or buy-outs of public shares at high market values (Damijan, 2012). The media report cases where loans were

Figure 1.6. **Portfolio composition of banks in Slovenia**[1]

Per cent of total loan portfolio, end of year[2]




1. Based on the latest data available, the share of each category of banks in terms of loans is 58% for large state-controlled, 8% for small domestic and 34% for foreign banks.
2. Loan portfolio is defined as total classified claims. For 2012 the data provided is for October.
3. Banks where the state holds, either directly or indirectly, a blocking minority shareholding: NLB, NKBM, Abanka, Banka Celje, SID banka and Gorenjska banka.

*Source:* Bank of Slovenia.

StatLink http://dx.doi.org/10.1787/888932797100

granted to related parties at favourable conditions. The two largest SOBs – NLB and NKBM – extended loans, amounting to, respectively, 20% and 15% of their capital, to the Zvon Ena financial holding company which is currently under bankruptcy procedures, and have also been heavily exposed to construction companies working on major public projects. Preliminary findings of the Slovenian Corruption Prevention Commission have recently pointed to widespread credit misallocation, likely related to corrupt behaviour.

Given weaknesses in corporate governance, there is uncertainty about the banks' judgment on the quality of loans, as well as fears that banks may try to evergreen bad loans (roll them over to avoid recognising losses on their books) in order to mask losses. Also, given low recovery rates after insolvency procedures, banks are dissuaded from extricating themselves from lending to financially distressed businesses and instead are extremely cautious when extending new loans (European Commission, 2012). Renegotiated loans amount to 150% of total loans in arrears over 90 days, which could signal forbearance that makes balance sheets look stronger because banks do not need to put aside provisions, but it can erode faith in the strength of bank assets. If loans are renewed or renegotiated when the indebted company is distressed, the losses might increase in the future because the underlying asset will decline in value if not properly managed. This is likely to happen when renegotiation allows for only the extension of deadline or repayment postponement and does not include partial debt forgiveness, which is frequently necessary to return the distressed but viable company to a healthy state. As discussed earlier, the amount of written off loans is negligible in Slovenia. The quality of renegotiated loans is not known, as the Bank of Slovenia does not collect data on the share of renegotiated loans that used to be overdue and the share of renegotiated loans that become overdue afterwards.

There is evidence of crowding out of private credit by credit to SOEs: irrespective of the bank ownership, the share of credit to SOEs rose from 3% to 7% between 2008 and 2012 (Figure 1.6). It is difficult to evaluate the riskiness of these loans as the Bank of Slovenia does not publish or provide the share of overdue loans to SOEs. There is no evidence of increasing financial repression, but domestic banks (SOBs and private) allocate larger shares of their portfolios in government bonds than foreign institutions, which could, in the current juncture, trigger a negative feedback loop between government and banks: as the perception of public fiscal sustainability by financial markets is weak, higher spreads on government bonds would lead to further deteriorating bank balance sheets, which would in return increase the potential fiscal costs of a bail-out of public banks. All banks appear to have significantly curtailed their lending to private firms (the share has dropped by more than 6 percentage points). In comparison, the share of households in portfolios of foreign banks has increased from 20% in 2008 to 28% in 2012, reflecting the relative health of foreign banks and their interest in the household sector (Figure 1.6).

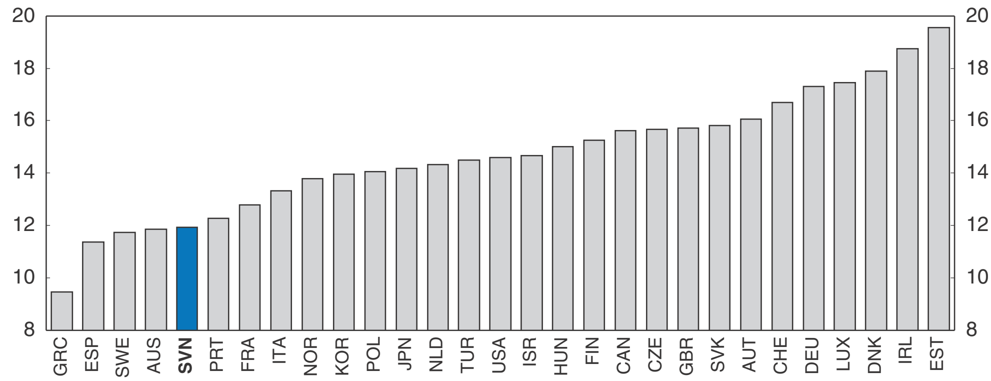
### *Bank solvency is under severe pressure*

High credit risk has increased the need for provisioning, putting pressure on the profitability of Slovenian banks that has been negative since 2010. In October 2012, the loss coverage ratio, i.e. the ratio of loan loss reserves to loans in arrears over 90 days, stood at 57%. However, it is important to note that between 2009 and the first half of 2011, banks were late to classify loans in higher provisioning categories even if they registered arrears, but the gap has been closing more recently. The provisioning is done in accordance with International Accounting Standards, in other words, on the incurred losses basis: this coverage ratio does not take into account expected losses on performing or restructured loans. Moreover, banks apply different provisioning methods that are not always comparable. For these reasons, the coverage ratio seems insufficient, especially since the amount of NPLs is very high in Slovenia. In order to ensure that adequate coverage exists when these loans migrate to the doubtful category, provisions should be set aside also for performing and restructured loans, as was done in Spain in May 2012, when provisioning rates on performing real estate developer loans were increased from 7% to 30%.

Despite deleveraging and several injections of public funds into SOBs, Slovenian banks remain under-capitalised relative to those in other OECD countries (Figure 1.7). The large state-controlled banks report a capital adequacy ratio of 11% and a Tier 1 capital ratio of 10% as of October 2012. The largest Slovenian bank, NLB, has been recapitalised twice in 2011 and 2012 to the amount of EUR 624 million (1.7% of GDP). The bank had announced that it would seek another recapitalisation of EUR 375 million in late 2012, but this plan was not approved by its shareholders and the Ministry of Finance argued that recapitalisation was not yet needed. At the end of December, KBC, the largest foreign

Figure 1.7. **Capital adequacy ratios**

Total regulatory capital as a per cent of risk-weighted assets, 2012[1]




1. Latest quarter based on available bank balance sheet data; third quarter of 2012 for the majority of countries shown.

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

StatLink *http://dx.doi.org/10.1787/888932797119*

(Belgian) shareholder, sold its 22% share in NLB to the Slovenian state for EUR 2.76 million. Following recommendations of the European Banking Authority, the second largest bank, the Nova KBM, was supposed to increase its capital till September 2012, and this was achieved at the end of December 2012 via the sale of its insurance subsidiary, the redemption/exchange of hybrid notes and sale of CoCo bonds (contingent convertible securities) to the state. So far, total recapitalisation by the state has reached 2.5% of GDP, but growing loan loss provisions erode potential increases in capital. The Tier 1 capital ratio of small domestic banks is below 9%. In contrast, foreign owners have recapitalised their Slovenian subsidiaries so that the total capital adequacy ratio of foreign banks has increased from 9.3% in 2007 to 13% in 2012 (Figure 1.5).

Capital adequacy ratios of Slovenian banks are likely to decline once bad loans are recognised and some of them are written off. The authorities evaluate additional recapitalisation needs at 3% of GDP. Yet, effective capital needs are uncertain and could in fact be significantly higher. While the central bank has performed stress tests (a top-down exercise based on macroeconomic scenarios) and a single consultancy firm, European Resolution Capital (ERC), has performed a due-diligence analysis of major banks (a bottom-up exercise with a loan-by-loan analysis), the main results have never been made public. This is in contrast to the practice in other countries facing severe banking difficulties, including the United States and Spain. While the due-diligence exercise was not officially made public, some experts argue that, six months after the exercise, its results are already outdated even under the stress scenario as the underlying assumptions were not sufficiently conservative and forward looking. Also, unofficial press reports suggest that the NLB suffered losses from Zvon Ena that are double of those estimated in the due-diligence report. Finally, it is not clear whether the assessment of the ERC and the Bank of Slovenia converge. According to the Slovenian Press Agency, some government officials claimed in mid-July 2012 that the due-diligence report and a report by the central bank show significantly different pictures.

To give an idea of the extent of potential recapitalisation needs, the OECD has done an illustrative estimation with two scenarios, based on data provided by the Bank of Slovenia. The idea is to identify potential capital shortage once estimated losses (which are a function of NPLs without taking into account collateral) are written off (see Box 1.1 for more details of the analysis). Results indicate that Tier 1 capital ratios of large state-controlled and small domestic banks have a high risk of becoming negative, whereas the ratio of foreign banks falls to 8-9%. The potential amount of recapitalisation could reach about 5% of GDP. These scenarios do not take into account collateral, which offers relatively poor protection in Slovenia as it mainly consists of real estate which is a non-liquid asset and subject to major valuation uncertainties (IMF, 2012a). However, assuming that banks can realise at once 10% of its value (EUR 6.4 billion) for claims in arrears over 90 days, then the potential capital shortfall could reach 3.2% of GDP. Conversely, capital requirements could be higher as the estimate does not take into account loans renegotiated before they became overdue or the use of more conservative risk-weights applied to assets, which could lead to additional losses. Overall, even though these scenarios are mainly illustrative, they reveal the extent of the problem for domestic banks, particularly the largest SOBs, while foreign banks appear to be in a better shape. It should be noted, however, that the proportion of loans in arrears of less than 90 days is higher for foreign banks than for domestic banks, which could indicate some further difficulties down the road for foreign banks also.

Looking at market valuation gives a similar perception of potentially weak capitalisation of some banks. As of 26 December 2012, the price-to-book ratios on the Ljubljana Stock Exchange of NKBM and Abanka, the second and the third largest banks, stood at 0.12 and 0.13 (i.e. markets valued the equity of these banks at 12% and 13% of their book value). Even though price-to-book ratios have declined in all countries, the average ratios stand at 1.7 in Latin America, 1.4 in eastern Europe and 0.8 in developed markets (McKinsey, 2012). The shares of NLB are not traded on the stock exchange, but at the end of December 2012, the government bought a 22% share from the Belgian KBC for 1% of its book value. These low market valuations of bank equity are consistent with the OECD estimate in Box 1.1 of the Tier 1 capital ratios after the write-off of estimated losses.

### Box 1.1. **Estimating capital shortfall of Slovenian banks**

Table 1.1 provides an OECD estimation of potential capital shortfall for the Slovenian banking sector as a whole and separately for large state-controlled, small domestic and foreign banks. To do so, the capital shortfall (in value) is calculated as core capital needed after the write-off of expected losses to reach a Tier 1 capital ratio of 9%. The following formula is used (with data in EUR):

$$\text{Capital shortfall} = 9\% * (RWA - EL) - (\text{Tier } 1 + LLR - EL)$$

where *RWA* represents "risk weighted assets", *Tier 1* the amount of "core capital", *LLR* the total of "loan loss reserves" and *EL* the OECD simulation of losses using different hypotheses (see below). To compute *EL*, two scenarios are constructed using different sets of assumptions. The first scenario is the most simple: it assumes that all loans in arrears over 90 days not covered by reserves need to be fully written off while no losses are assumed for loans in arrears of less than 90 days. The second scenario is a bit more sophisticated and assumes different probability of losses depending on the duration of arrears: 20% loss rate is assumed for claims that are in arrears for less than 30 days; 30% for loans that are in arrears between 30 and 90 days; 70% for those between 90 days and one year and 100% for claims that are in arrears for more than one year. Such assumptions of loss rates are based on OECD (2012).* Interestingly, both scenarios provide quite similar results, at least at the aggregated level.

## Box 1.1. **Estimating capital shortfall of Slovenian banks** *(cont.)*

### Table 1.1. **Estimating the capital shortfall of Slovenian banks**

September 2012

| | All banks | Large state-controlled[1] banks | Small domestic banks | Foreign banks |
|---|---|---|---|---|
| **Current situation** | | | | |
| Total claims (billion EUR) | 49 | 30 | 4 | 15 |
| Claims in arrears (% of total claims) | | | | |
| Below 30 days | 4.1 | 3.7 | 2.2 | 5.4 |
| Between 30 and 90 days | 1.8 | 1.9 | 1.7 | 1.7 |
| Between 90 days and 1 year | 4.8 | 5.5 | 7.2 | 2.4 |
| Over 1 year | 9.5 | 12.4 | 7.7 | 4.1 |
| Tier 1 capital ratio (% of risk weighted assets, RWA) | 10.2 | 9.8 | 8.6 | 11.4 |
| **First scenario: 100% losses for loans in arrears over 90 days** | | | | |
| Estimated losses (billion EUR) | 7.0 | 5.3 | 0.7 | 1.0 |
| Loss coverage ratio (loan loss reserves/estimated losses, %) | 55.4 | 55.0 | 45.1 | 65.3 |
| Resulting Tier 1 capital ratio after losses are written off (% of RWA) | 1.8 | -1.5 | -2.3 | 9.0 |
| Resulting capital shortfall (billion EUR) | 1.9 | 1.8 | 0.3 | -0.1 |
| Resulting capital shortfall (% of GDP) | 5.4 | 5.1 | 1.0 | -0.3 |
| **Second scenario: Loss rate function of the duration of arrears** | | | | |
| Estimated losses (billion EUR) | 6.9 | 5.2 | 0.6 | 1.1 |
| Loss coverage ratio (loan loss reserves/arrears over 90 days, %) | 55.7 | 56.0 | 49.3 | 57.6 |
| Resulting Tier 1 capital ratio after losses are written off (% of RWA) | 1.9 | -0.9 | -0.3 | 7.7 |
| Resulting capital shortfall (billion EUR) | 1.9 | 1.7 | 0.3 | 0.0 |
| Resulting capital shortfall (% of GDP) | 5.3 | 4.7 | 0.8 | 0.1 |

1. The category "large state-controlled" covers banks where the state holds, either directly or indirectly, a blocking minority shareholding. It covers the following: NLB, NKBM, Abanka, Banka Celje, SID banka and Gorenjska banka. Based on the latest data available, the share of each category of banks in terms of loans is 58% for large state-controlled, 8% for small domestic and 34% for foreign banks.

*Source:* OECD calculations based on Bank of Slovenia data.

A few caveats should be applied to this analysis. Capital shortage could be lower as the estimate does not take into account collateral that could diminish losses, as collateral offers relatively poor protection in Slovenia as it mainly consists of real estate which is a non-liquid asset and subject to major valuation uncertainties (IMF, 2012b). Conversely, capital requirements could be higher as the estimate does not take into account loans renegotiated before they became overdue, but which could be subject to additional losses. More generally, the capital adequacy depends crucially on the risk-weights applied to assets. According to IMF (2012a), employment of enhanced capital measurement techniques, such as the Basel II internal rating based approach to credit risk, would increase capital requirements and would result in additional capital shortfalls.

* References: OECD (2012), *OECD Economic Surveys: Hungary 2012* and IMF (2012b), "Republic of Slovenia: Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision", *IMF Country Report*, No. 12/324, International Monetary Fund.

## As many banks remain fragile, a comprehensive restructuring of the banking sector is needed

Given the problem of high NPLs and the banks' inability to deal with them, the Bank Asset Management Company (BAMC), created in October 2012, could be seen as one element of the banks' restructuring and resolution framework (Box 1.2). The aim is to take over non-performing assets in return for government-guaranteed bonds of up to EUR 4 billion (11% of GDP) and recapitalise participating banks at up to 3% of GDP (EUR 1 billion). Yet, the creation of the BAMC should be part of a more comprehensive restructuring of the banking sector. According to best practice, resolution procedures should involve independent due-diligence of the whole banking sector to divide banks into four groups: *i*) solvent institutions; *ii*) viable banks that are currently distressed but can solve their problems without intervention; *iii*) viable banks that are currently distressed

### Box 1.2. **Bank Asset Management Company (BAMC)**

*Druzbo za upravljanje terjatev bank (DUTB)*

The law establishing the BAMC was passed on 23 October 2012. The objective of the BAMC is to enhance the stability of the Slovenian banking sector by purchasing non-performing assets and recapitalising banks. The law also states that the BAMC has the mandate to establish responsibility for the emergence of impaired loans and investments.

The description of risky assets that can be transferred will be determined by a government executive act and the price of transferred claims should reflect their real long-term economic value. The BAMC will be obliged to sell at least 10% of the estimated value of the assets each year and will be wound down after five years. The assets of the BAMC may be used to increase the equity capital of banks.

The BAMC will be financed with bonds, loans or other financial instruments which are guaranteed by the state and their issuance will take into account the conditions of the European Central Bank for financing financial institutions. The total scope of guarantees should not exceed the established ceiling of EUR 4 billion (11% of GDP).

The BAMC management board shall have seven members of which three will be executive directors selected on the basis of a public call for applications and should comply with professional requirements (personal integrity, university degree, expertise in finance, banking corporate law and is not a bank shareholder), whereas non-executive directors shall be proposed by the Ministry of Economy. Their remuneration will be decided by the Assembly and not be constrained by the rules governing remuneration of public employees. Supervision of the BAMC shall be performed by the Ministry of Finance.

The initiative for the application may be submitted by the BAMC, the bank or the Bank of Slovenia. The inter-ministerial committee (consisting of eight members appointed by the Government and the Bank of Slovenia) will assess business strategy of the banks. The government will issue an executive act that determines the requirements that banks must ensure, such as approvals of loans to small and medium-sized companies, the use of cash assets received, the remuneration, the level of assets, distribution of dividends, etc.

The BAMC shall disclose to the public all information that is relevant to the company's operations, as applies to joint stock companies, excluding data which are considered confidential in accordance with the act regulating banking. The BAMC shall report annually to the National Assembly and prepare annual financial statements and a business report (the balance of assets, liabilities, revenues and expenses).

and require intervention; and *iv*) non-viable banks that need to be closed in an orderly way. Such classification of banks was used in Spain and Sweden, and is supported by the Bank of Slovenia. The current legislation on the BAMC does not rely on such classification and it is not clear which banks will participate in the transfer of assets.

### *The creation of the BAMC could speed up the resolution of NPLs but the process has to be transparent and independent*

There are a number of advantages to the creation of the BAMC to purchase troubled assets. First, the remaining cleaned-up bank will be able to focus on normal banking operations, while the BAMC will specialise in the recovery of bad assets. Concentration of all bad loans in one bank can be particularly helpful in Slovenia, where companies have multiple banking relationships that create obstacles to debt restructuring due to difficult negotiations between multiple parties. Second, transparently executed, cleaning-up of banks' portfolios will provide them with a fresh start, simplify their access to the capital market, and increase their chances to be sold to a strategic private investor. Importantly, the BAMC should be used to dispose transferred assets rather than to undertake a corporate restructuring of underlying companies. The rare example of successful management of corporate restructuring is that of Sweden in the 1990s where the success was guaranteed by professional management, political independence, appropriate funding, adequate bankruptcy laws and transparency in operations and processes (Klingebiel, 2000).

In light of these advantages, a number of OECD countries have established asset management companies. Ireland and Spain have decided to transfer bad assets to a centralised asset management company, Switzerland has established an off-balance sheet special purpose vehicle tailored for UBS, and Denmark has chosen to separate a bad bank from a good bank as a tool of bank resolution (Table 1.2). In light of previous experience, both stages in the work of the BAMC – the selection and pricing of assets to be transferred and their subsequent management – should be conducted in an independent, accountable and transparent way.

The choice and pricing of non-performing assets and the subsequent identification of the resulting equity gap are crucial. The authorities prefer a tailor-made approach that would differ from asset to asset and bank to bank. However, best practice suggests that, to avoid adverse selection problems, the authorities have to define asset classes that can be transferred and banks should transfer either all or none of the assets in a given category. Moreover, to motivate banks to be transparent, the transfer of assets should be structured as a one-off opportunity to get rid of bad assets. Current law states that transferred claims have to be priced according to their "real long-term economic value". Even though the process of pricing has to be agreed with the European Commission within the State Aid guidelines of the Directorate General for Competition, the authorities could have incentives to overestimate the price of transferred assets in order to minimise immediate recapitalisation costs of banks. This approach transfers the problem to the BAMC and pushes the cost recognition into the distant future.

To determine a credible discount rate for the ring-fenced assets, international best practice is that due-diligence analysis needs to be performed. To increase its credibility, it should be conducted not by one consultancy, but several, in cooperation with international institutions. For example, in Spain the due diligence was performed by six firms (Oliver Wyman, Ernst&Young, KPMG, PwC, Deloitte and the Boston Consulting Group) while

Table 1.2. **Bad bank practices in OECD countries**

| | **Slovenia** | Denmark | Germany | Ireland | Spain | Sweden | Switzerland |
|---|---|---|---|---|---|---|---|
| Name | Bank Asset Management Company (BAMC); Druzbo za upravljanje terjatev bank (DUTB) | Amagerbanken, subsidiary of the Financial Stability Company | Bundesanstalt für Finanzmarktstabilisierung (Federal Agency for Financial Market Stabilisation, FMSA) | National Asset Management Agency (NAMA) | Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB) | Securum and Retrieva | StabFund |
| Date of establishment | 2012 | 2011 | 2008 | 2009 | 2012 | 1992 | 2008 |
| Expected duration | 5 years | It is a new bank | When resolution is complete | Till the Minister for Finance determines that its mission is completed | 15 years | 15 years, but liquidations were completed in 1997 | 8 years, extendable to 12 |
| Type of bad assets to be transferred | Not clear | All assets of the bank that is wound-down | No restriction concerning asset classes | Loans for land and development purposes and associated property loans | Mainly loans to real estate developers and foreclosed real estate | Real estate assets | Securitised loans, including sub-prime mortgage loans |
| Pricing of bad assets, discount | Not clear | The transfer sum was considerably lower than the existing book value less further loan impairment charges | Transferring banks are obliged to compensate for the losses | Discount 57%. Theoretically, long-term economic value, but closely aligned to the current market value of collateral | Long-term economic value. Discounts (46-63%) based on the independent due diligence | Assets were transferred at book value | Book value with discounts. Pricing rules are public information |
| Financing | Government guaranteed bonds | Subject to bank capital requirements | Own funds and loans issued by the Ministry of Finance | Equity = 0.8% of assets | 10% equity. Private equity, perhaps government equity and government-guaranteed bonds | Deliberate overcapitalisation enabled the asset management companies to carry out their salvage operations autonomously | 10% equity from UBS and 90% with Swiss National Bank loan. Public guarantees |
| Role of independent experts in valuations | None | Two auditors appointed by the Institute of State Authorised Public Accountants | None | Competitive public procurement process to find professional advisors to carry out the due diligence | Valuations by external consultancy firms under supervision of European Central Bank and International Monetary Fund | Bank Support Authority, independent of the Ministry of Finance and the central bank | No decision role |

*Source:* Law on Slovenia's Measures to Strengthen Bank Stability, September 2012; Danmarks Nationalbank (2011), *Financial Stability 2011*; Act on the Establishment of a Financial Market Stabilisation Fund (Germany); National Asset Management Agency (Ireland) *www.nama.ie*; and OECD (2011), *OECD Economic Surveys: Switzerland 2011*, Ergungor, O.E. (2007), "On the Resolution of Financial Crises: The Swedish Experience", *Policy Discussion Papers*, No. 21, Federal Reserve Bank of Cleveland; and OECD Economics Department.

macroeconomic scenarios were defined in cooperation with the European Commission, the European Central Bank, the European Banking Authority and the International Monetary Fund. In contrast, the due-diligence analysis of key Slovenian banks was carried out by a single consultancy firm (European Resolution Capital), chosen because its offer was the cheapest. The main results were not made public, but its methodology appears to be not sufficiently forward-looking as discussed earlier. To foster the credibility of the BAMC, a new bottom-up due diligence exercise should be performed, accompanied by a top-down stress test by the central bank. The main underlying assumptions and results of both exercises should be made public so as to reduce market uncertainties regarding the needs for public recapitalisation.

Once the equity gap is identified, banks need to be recapitalised. It is important that banks are recapitalised with cash rather than state-guaranteed bonds, because non-cash recapitalisation would postpone cost recognition for the budget and further reinforce the negative feedback loop between the solvency of the government and the banks. Hence, capital ratios of distressed but viable banks should be increased, preferably by issuing shares, as advised by the ECB (2012). To reduce the need for tax-payer revenues to bail out failing banks, the authorities should also consider a bail-in option, which would also help reducing the negative feedback loops between government finances and the financial systems (Financial Stability Board, 2011).

NLB and the NKBM have bought their hybrid capital instruments at a discount of 40-50%. However, holders of subordinated debt should also absorb losses of banks that are resolved or are recapitalised by the government. The amount of subordinate debt is not negligible: about 3% of total banking assets. Fiscal costs could be reduced further by also imposing losses on senior debt for banks put into resolution. It is important to stress that bail-in may increase the funding costs of Slovenian banks perceived as being at risk of becoming non-viable in the future and thus subject to future bail-ins, deterring potential investors. Hence, it is important to carefully design the bail-in strategy to reduce that risk (IMF, 2012b).

The current legislation gives very broad powers to the BAMC to undertake bank restructuring that goes beyond traditional functions of an asset management company. This might raise concerns if the BAMC uses its powers to oblige banks to convert debt into equity and, hence, both banks and their debtors would be owned by the state. A special warning should be issued regarding the power of the BAMC to determine requirements that participating banks must ensure, such as, for example, lending to SMEs. Such an approach closely resembles the decision of the Japanese government to require recapitalised banks to increase lending to small and medium-sized enterprises (SMEs), leading to large non-performing loans in this sector (Hoshi and Kashyap, 2010). If the government plans to privatise SOBs, such requirements can be perceived as continued political interference and would discourage potential investors. Although other governments have imposed a number of restrictions on banks that required state assistance, they usually aimed to increase retained earnings by limiting salaries and dividend distribution.

To be robust, the corporate governance of the BAMC must be backed by strong independence and accountability. The current law could set the stage for independent management because it foresees a public call for applications and the possibility of competitive salaries to attract reputable managers. Some managers have already been appointed. A potential weakness is that non-executive directors of the management board and members of an inter-ministerial committee, who will assess the business strategy of banks, do not have to fulfil any professional requirements and could hold political positions. Moreover, there is a potential conflict of interest as the Ministry of Finance will combine the roles of owner and supervisor of the BAMC, while the role of the Bank of Slovenia in the supervision of the BAMC is unclear.

Strengthening financial independence is another issue. If BAMC is financed by guaranteed debt with almost no equity, this reduces the immediate impact on the budget deficit, but it creates poor incentives for managers who will be reluctant to sell assets at a loss in order to avoid that state guarantees are effectively enforced and lead to budgetary expenditures. The current law does not specify what happens with losses or profits of the BAMC at the end of its mandate. Even though BAMC debt is guaranteed by the state, the absence of capital buffers will also deter private investors who could be interested in buying BAMC bonds. The Swedish experience demonstrates that asset management companies require sufficient funding and even have to be overcapitalised in order to be autonomous and free from political interference (Ergungor, 2007). Hence, the BAMC should be sufficiently capitalised, preferably with the participation of private investors. Finally, the five year mandate appears rather short and could be extended to 15 years (as is the case in Ireland, Spain and Sweden), notably to minimise taxpayer costs. Concomitantly, the currently foreseen requirement that all assets that are not disposed by the BAMC within its term will be transferred to the recently created sovereign holding company should be scrapped as this could potentially lead to a permanent postponement of the crisis resolution. There is also no reason to believe that the holding would be better able to manage impaired assets than the BAMC.

The independence of the BAMC requires full transparency in order to make it accountable. The law foresees annual reports of the BAMC to parliament, which is not sufficient in a crisis environment when the situation changes very rapidly. The BAMC should be required to disclose information on the transferred assets, including refinancing, restructuring and disposal. The Irish National Asset Management Agency publishes news on its activity and quarterly reports on its webpage, while the US Treasury Department that manages the Troubled Asset Relief Program provides daily updates. Hence, the creation of the webpage that transparently explains the process and publishes at least quarterly reports would be essential.

***Restructured banks should be promptly privatised***

Since the crisis has affected the solvency of SOBs much more than that of private foreign institutions, and, to a lesser extent, private domestic banks, this raises the question about their ability to prevent future misallocation of credit. As previously discussed, SOBs have the largest share of NPLs, suggesting inadequate risk management. Moreover, the two largest SOBs – Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) – appear to be among the least efficient banks in the country, particularly on a profit basis, as analysed in the chapter on foreign investment, governance and economic performance of the 2011 *Economic Survey* of Slovenia (OECD, 2011b). This result is not surprising as there is a large cross-country literature that shows that state ownership of banks is less efficient than private ownership, while privatisation and foreign bank entry have a salutary effect on banking sectors (Bonin et al., 2005). Hence, the prevailing consensus calls for privatisation of SOBs.

The Slovenian authorities have announced that they are willing to reduce their share in the largest three SOBs to the blocking minority of 25% plus one share. The decision to privatise is welcome, but international experience shows that partial privatisations thwart true reforms and often lead to additional recapitalisation (Andrews, 2010). Moreover, the residual possibility of state intervention will deter foreign investors.

In 2001, the government already announced the privatisation of the two largest banks (NLB and NKBM) through a tender which was only partly successful. Due to public outcry against selling the "family silver" to foreigners, the Belgian bank KBC was allowed to acquire only 34% of shares in NLB. According to the tacit agreement with KBC, it appears that the government promised to allow KBC to become the majority shareholder. Yet, the negotiations failed in 2004 and KBC proclaimed that it would turn from a position of strategic investor to the position of portfolio investor. As to the NKBM, only three institutions that showed interest met the minimal requirements to be taken seriously as bidding offers: Italian bank Unicredito, Austrian Bank Austria and Activa Group. Government representatives stated publicly their disappointment that no "major" bank expressed interest in NKBM and one year later decided that none of the bidders met the necessary conditions (Lindstrom and Piroska, 2007).

Such an unsuccessful previous experience with privatisation means that the government will need to work hard to attract reputable foreign investors. Privatisation of SOBs should follow immediately after the cleaning-up of their portfolios by transferring bad assets to the BAMC. All successful bank privatisations have been achieved through some form of share sale and have involved a strong financial institution as a significant strategic shareholder. This can be achieved through a sale by competitive and transparent tender. Most likely such an investor will be foreign. As with any change in bank ownership, the supervisory authority should ensure that the new owners are fit and proper, management is competent and experienced, the source of capital is verified, and the business plan is viable.

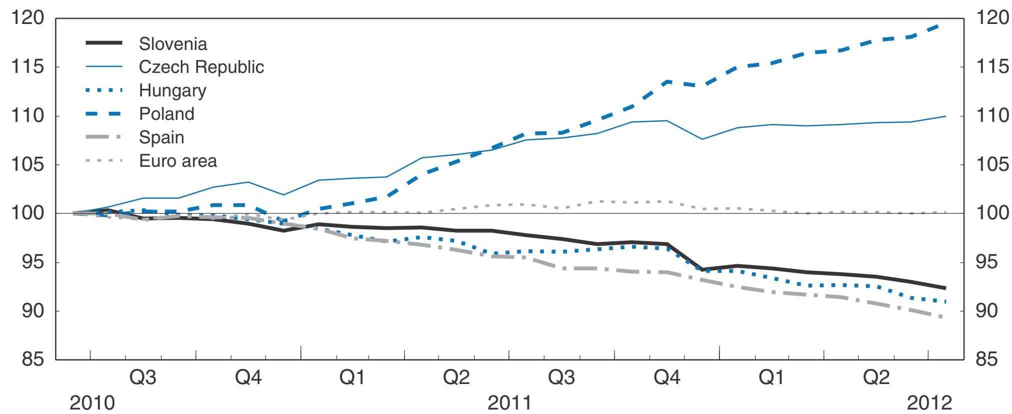
## Deleveraging of the corporate sector

International experience suggests that crises preceded by credit booms tend to be followed by sizeable deleveraging (Tang and Upper, 2010). Deleveraging will inevitably hurt growth, but it is a necessary process to both reduce risks that over-indebtedness poses to the economy and to lay the foundations for a sound recovery. The issue is not to slow down or impede this process, but to mitigate the negative impact on activity. To achieve a smooth deleveraging of the non-financial corporate sector, three conditions should be fulfilled. *First*, it is essential to repair bank balance sheets and to ensure the recapitalisation of viable banks, as discussed earlier. If banks are not adequately capitalised and burdened with bad loans, they are likely to shrink their assets faster than desired in order to increase their capital ratios. Moreover, there is a risk that banks have incentives to "evergreen" bad loans and to "gamble for resurrection" by issuing high-risk high-return loans (Caballero et al., 2008). *Second*, smooth deleveraging requires an efficient insolvency framework to ensure that viable but distressed enterprises are restructured while insolvent firms are swiftly liquidated. *Third*, corporate deleveraging should be achieved not only via a decrease in debt, but also via an increase in equity, to avoid too negative an impact on activity.

The deleveraging has barely started in Slovenia. Even though there is a sizable drop in the amount of outstanding credit to non-financial corporations, which compares poorly in international perspective and illustrates the weakness of the economic situation in Slovenia (Figure 1.8), the decline in equity has offset a large part of it, resulting in only a small decline in debt-to-equity ratios (Figure 1.2). New loans decline, notwithstanding the economic sector. To spur loan growth, the authorities introduced a tax on banks' balance sheets in mid-2011 that is expected to last till end-2014. A tax rate of 0.1% is applied on banks' assets and the levy can be reduced if banks grant loans to non-financial entities (and the conditions to decrease the tax base were tightened in December 2012). However, it is not wise to try to delay the necessary deleveraging and the bank levy should be repealed. In any case, the tax is not effective as weak credit activity is caused by poor bank health, decline in foreign funding not fully compensated with Eurosystem liabilities (Figure 1.9) and weak loan demand since 2011 (Figure 1.10). Previous international experience shows

Figure 1.8. **Outstanding loans to non-financial corporations**

Index, June 2010 = 100

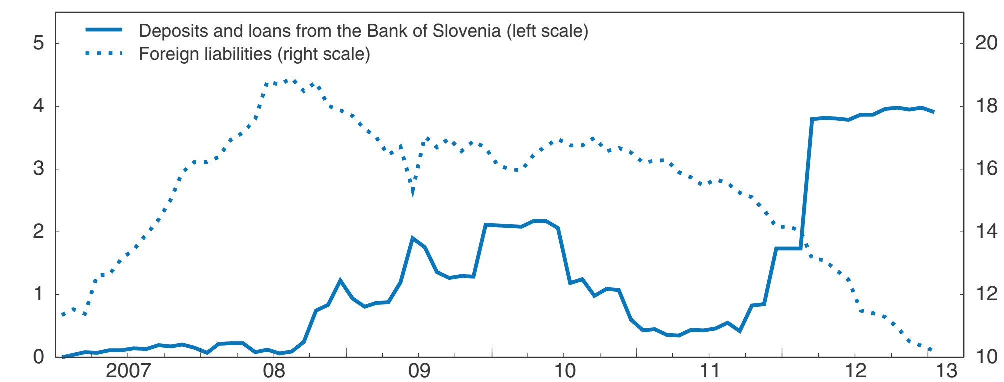



*Source:* MNB (2012), *Report on Financial Stability*, November, Magyar Nemzeti Bank and Bank of Slovenia.

StatLink http://dx.doi.org/10.1787/888932797138

Figure 1.9. **Development of foreign liabilities and liabilities from the Eurosystem**

Thousand euros

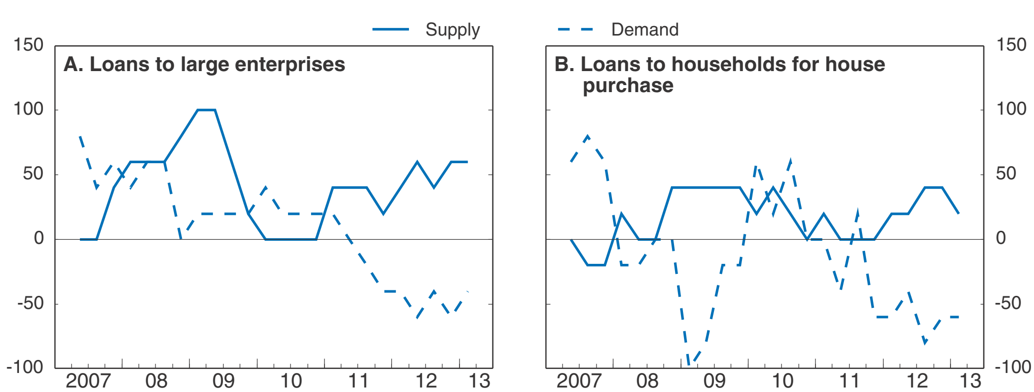



*Source:* Bank of Slovenia (2013), *Monthly Bulletin*, February.

StatLink http://dx.doi.org/10.1787/888932797157

Figure 1.10. **Credit conditions and credit demand evolution**

Net percentage,[1] positive numbers indicate tightening of credit standards or increased loan demand




1. The net percentage is the frequency of tightened minus that of eased or reverse conditions over the previous three months based on the opinions of senior loan officers of a representative sample of banks.

*Source:* ECB (2013), "Bank Lending Survey", *Statistical Data Warehouse*, European Central Bank, March.

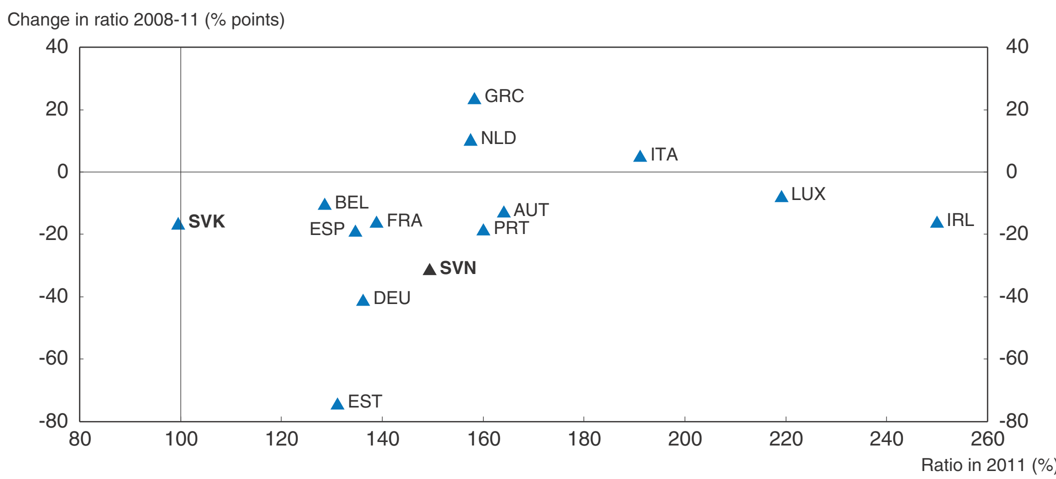
StatLink http://dx.doi.org/10.1787/888932797176

that deleveraging lasts between five and ten years with an average of 8.3 years (Ruscher and Wolff, 2012).

The duration of deleveraging can be particularly long for countries whose loan growth was financed by cross-border loans instead of deposits. The loan-to-deposit ratio in Slovenia, at around 136% (October 2012), is high in international comparison (Figure 1.11). In a number of countries banks are decreasing their loan-to-deposit ratio either due to new regulation (the authorities have limited this ratio to 110% and 120% in respectively Austria and Portugal) or due to financial constraints. Slovenian banks have also reduced their reliance on foreign funding and domestic banks reported a loan-to-deposit ratio of 113% in October 2012, while the ratio for foreign banks is 180%. However, to prevent the return of external risks in the future, setting a 120% loan-to-deposit target for banks could be an option. It will concern primarily foreign banks and it should be reached very gradually to avoid unduly hurting economic activity and disorderly withdrawal of funding.

Figure 1.11. **Loan-to-deposit ratio in the euro area has declined**[1]

Loans to banks and non-banking sector/non-banking sector deposits




1. Domestic banking groups and stand-alone banks, foreign controlled subsidiaries and branches. Loans and receivables including finance leases and total deposits other than from credit institutions, both in per cent of total assets.

*Source:* ECB (2013), "Statistics on Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, January.

StatLink http://dx.doi.org/10.1787/888932797195

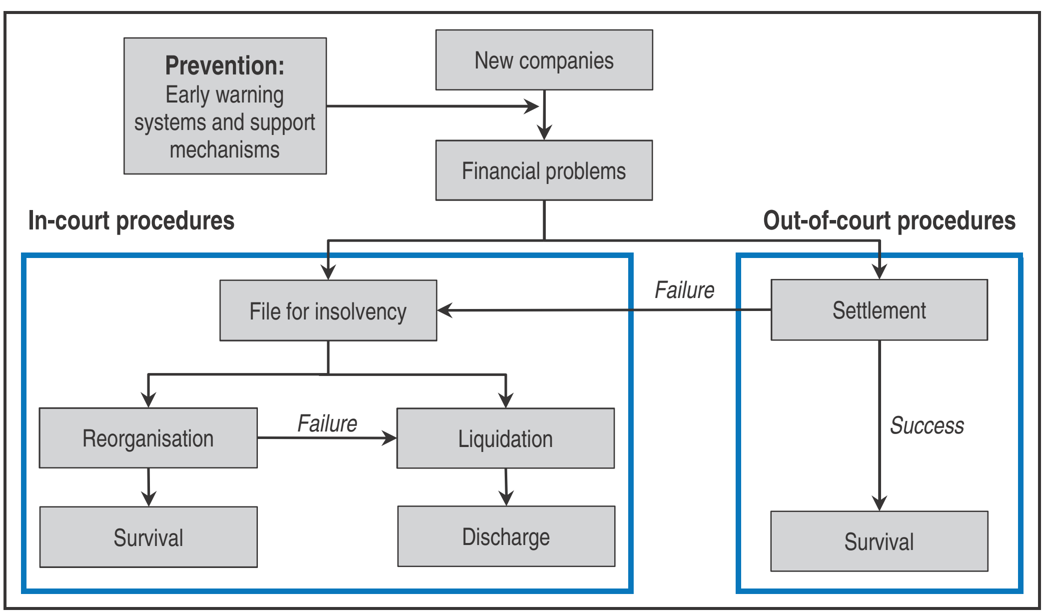
### *Inefficient insolvency procedures are the main obstacle to corporate NPLs resolution*

In Slovenia, liquidation is often the only option for distressed businesses and restructuring is rare and difficult due to a number of obstacles. *First*, many firms (particularly large ones) have banking relationships with many banks simultaneously, which complicates negotiations between different parties. Banks are not always aware about the credit history of their clients with other banks and might learn too late about firms' arrears at other banks. Firms do not disclose their distressed situation to all banks simultaneously but try to negotiate individually with different banks. *Second*, owners of firms do not have the cash to provide additional capital, particularly in the case of firms that were bought during leveraged buyouts and whose owners are highly leveraged themselves. To deal with this problem banks rely on debt-equity swaps for the case of the firms with the best prospects, but this practice remains rare. *Third*, the insolvency framework is long and inefficient, resulting in very low recovery rates.

### *Debtors and creditors should resort early to insolvency procedures*

The insolvency framework involves a number of possible pathways between the start of a new company, early warning systems, potential financial problems, firm survival due to reorganisation (out-of-court or in-court) and liquidation in the case of the failure of the above preventive measures (Figure 1.12). The European Union encourages national authorities to design insolvency procedures that are quick and easy – lasting no more than a year. According to the World Bank 2012 *Doing Business* indicators, it takes on average 24 months to complete a standard bankruptcy procedure (with a main secured creditor and several unsecured ones) in Slovenia. By contrast, it is possible to do this in less than one year in a number of OECD countries, including Belgium, Canada, Finland, Ireland, Japan or Norway (Figure 1.13). More importantly, the duration is much longer for large complex businesses with numerous creditors and it usually takes three or more years in such cases. Unfortunately, most large corporate NPLs belong to this category and courts face many difficulties to resolve complicated cases.

Figure 1.12. **Overview of the insolvency process**

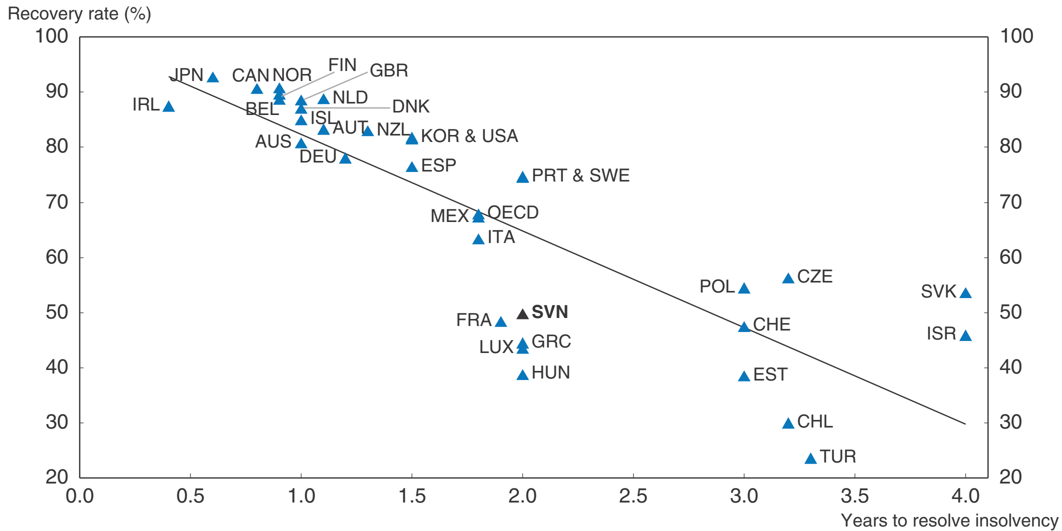



*Source:* Based on European Commission (2011), "A Second Chance for Entrepreneurs: Prevention of Bankruptcy, Simplification of Bankruptcy Procedures and Support for a Fresh Start", Final Report of the Expert Group.

The duration of insolvency procedures is crucial because it is negatively correlated with recovery rates: the slope of the line in Figure 1.13 suggests that an additional year spent on litigation decreases the recovery rate by 16 percentage points. While Slovenian investors can recover only 51% of assets, best practices show that it is possible to achieve recovery rates above 90% (Canada, Japan and Norway). Such high rates are achieved by rapid bankruptcy procedures that last 6, 8 and 9 months, respectively (Figure 1.13). Hence, decreasing the duration of the insolvency procedures must be the priority of the

Figure 1.13. **Efficiency of the insolvency law**

2012[1]




1. To make the data comparable across economies, several assumptions about the business and the case are used. For details see: *www.doingbusiness.org/methodology/resolving-insolvency*. The OECD aggregate is an unweighted average.

*Source:* World Bank (2012), *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises*, World Bank Group.

StatLink http://dx.doi.org/10.1787/888932797214

bankruptcy framework. The statistics of the Slovenian Ministry of Justice show a positive trend, as the share of bankruptcy cases that take more than two years has decreased from 21% in 2009 to 10% in 2011. Unfortunately, these statistics are not representative for insolvencies that result in NPLs, and there are no signs of improvement for the latter cases.

One of the main reasons why bankruptcy procedures take a long time and the recovery rate is low is the fact that they are initiated too late, usually when it is impossible to save the enterprise. According to Slovenian law, there are two alternative definitions of insolvency: *1)* liquidity approach (when the company is late for more than two months in meeting its liabilities in a total amount exceeding 20% of the amount of total liabilities) and *2)* balance sheet approach (if the value of assets is smaller than the sum of liabilities). Yet, the emphasis is much more on the first approach and a company that is balance sheet insolvent can effectively challenge its creditor in court if it can demonstrate that it still can meet its obligations. Insolvent companies that succeed in refinancing their credits can stay insolvent for prolonged periods of time before applying for bankruptcy and this would be in line with the current legislation. Such a situation should be changed and companies that are balance sheet insolvent should be obliged to apply for bankruptcy.

Even when the law obliges insolvent firms to apply for bankruptcy (otherwise they are liable for the financial damages arising from the delay), many firms postpone the announcement of their insolvency, try to buy time and gamble for resurrection. *De facto*, there are no sanctions against such fraudulent behaviour. It is important to ensure that the existing law is enforced and firms should be encouraged to apply for bankruptcy as early as possible. Otherwise, the debtor should carry civil and, where appropriate, criminal responsibility, as is the case in France or Germany. To motivate entrepreneurs to apply early, the bankruptcy procedures should distinguish between honest and fraudulent bankruptcy and honest businessmen should receive a fresh start after the end of bankruptcy procedures (European Commission, 2011a). Judges should be trained in how to act in cases of fraudulent bankruptcy.

### *The legal framework for in-court and out-of-court restructuring should be improved*

International experience shows that in-court reorganisation, such as "Chapter 11" in the United States, is one of the most efficient procedures. Although the Slovenian legislation has proposed such an option since 1999 (insolvency compulsory settlement procedure), it is rarely used. In 2011, there were only 26 cases resolved by the in-court restructuring procedures. There are a number of reasons for this. According to the *Business Dynamics Survey 2010*, businesses are not always aware of this option (European Commission, 2011b). Even if borrowers are aware, the existing in-court restructuring procedures are considered to be too costly and complex, which discourages particularly small and medium enterprises that are left with bankruptcy as the only viable option. A plan to introduce fast-track simplified procedures for micro enterprises and sole proprietors is a welcome step in the right direction.

Firm reorganisation can also be achieved by voluntary out-of-court restructuring that provides a speedy and cost-effective tool to achieve debt settlement (EBCI, 2012). Although allowed under the Slovenian insolvency law, it is not explicitly regulated and no official data is collected on these procedures. According to the *Business Dynamics Survey 2010*, the average time of an out-of-court restructuring is 8.5 months which is rather high in international comparison (European Commission, 2011b). To speed up this process, out-of-court restructuring should be regulated either by a set of principles or by a law, in line with the INSOL principles (International Association of Restructuring, Insolvency and Bankruptcy Professionals). If creditors lend money to businesses under such procedures, they should receive priority in the payment of claims, making it more likely that distressed businesses would get new loans.

### *Liquidation of failed enterprises should be speeded up*

If a company is not viable, it has to be liquidated under the court supervision. The authorities can take a number of steps to render these bankruptcy procedures more efficient. One of the possible tools can be the establishment of time limits. Currently, the law limits the evaluation stage of the bankruptcy procedures to seven months, but this limit is often exceeded. It is important to ensure that the current legislation is enforced and, then, to attempt to decrease the time of this procedure even further. Moreover, the World Bank advises to introduce a time limit to the overall bankruptcy procedure, including the litigation stage. In exceptional cases, the duration could be changed at the discretion of a judge. The efficiency of the bankruptcy procedures is related to adequate staffing of courts and professionalism of judges and receivers. According to the 2012 *Economic Freedom Index*, courts are understaffed, but experts agree that there is also scope for increasing efficiency of judges. The establishment of judges that specialise in bankruptcy procedures is a welcome step forward.

Another way to increase the efficiency of the system is to render it more transparent, thus, increasing the accountability of judges. Slovenia has made impressive progress in this respect. Information about initiated and resolved bankruptcy cases is published online. Moreover, in 2008, the Supreme Court established a computerised case management system (Judicial Data Warehouse) that collects data on a large number of indicators that, on the one hand, help judges to reach faster and fairer judgments and, on the other hand, permits a comparison of the performance of similar courts. This system appears to improve the management of human resources between courts, having a positive effect on the speed of litigations and reducing the backlog.

The judicial decisions should be not only swift, but also fair. Yet, according to the 2012/13 *Global Competitiveness Report* (WEF, 2012), the Slovenian judiciary is not independent from influences of members of government, citizens, or firms. Among OECD countries, only six members show larger external influences (Czech Republic, Greece, Hungary, Korea, Mexico and Turkey). The 2012 *Economic Freedom Index* documents a gradual progress, but it also shows that the judicial framework remains vulnerable to political interference. Recent media reports point to some cases where judges and receivers have improper ties and several investigations were launched in September 2012. It is not surprising, that if the judicial process is perceived to be partial, debtors and creditors are discouraged from resorting to it. One can hope that the computerised case management system will be used to increase the accountability of judges and control fairness of their decisions.

### *Development of the equity market can help smooth deleveraging*

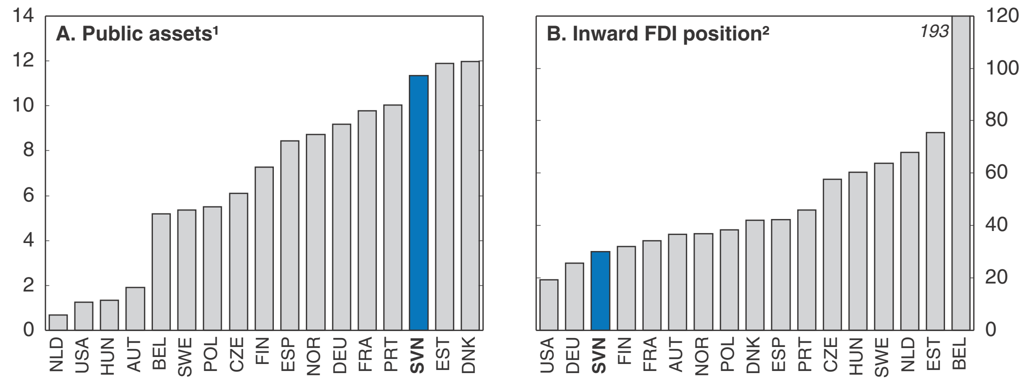
In the corporate sector, debt-to-equity ratios have fallen driven by a decline in lending, the largest construction companies went bankrupt and the state has transferred some assets to the transportation company DARS. But the deleveraging of the non-financial sector should be achieved not only through debt reduction but also by raising equity on the stock market and attracting foreign capital to viable enterprises. This would not only smooth the deleveraging of Slovenian non-financial corporations, but would also strengthen their corporate governance and market discipline. Foreign direct investment has been low and public ownership remains high in Slovenia (Figure 1.14). Hence, privatisation of non-financial corporations supported by the definition of a clear asset management strategy, underpinned by a well-defined distinction between strategic and non-strategic holdings, could attract valuable equity. Alternatively, the banks could contribute to repair the balance sheets of ailing businesses through debt-to-equity swaps. Yet this would increase the already large state ownership in the economy even more and, given Slovenia's poor governance, delay necessary deleveraging.

The development of the stock market is stifled by the high share of state ownership in the ten largest listed companies, limited protection of minority shareholders and ineffectiveness of supervision by the Securities Market Agency (SMA). As mentioned earlier, the large share of NPLs is attributed to financial holding companies used in privatisation through leveraged buy-outs and the underlying companies that were subject to buy-outs. There are concerns that a number of high profile takeovers have been done in apparent circumvention of the mandatory bid provisions of the takeover law. Amongst the management buy-outs that have occurred, many experts felt that "share parking" in advance of takeovers had become widespread and the supervising agencies had exhibited little real power to ensure effective disclosure (OECD, 2011a).

The SMA appears to have lacked the capacity and willingness to pursue enforcement action with respect to such takeovers, perhaps reflecting its lack of *de facto* independence (ranked 73 according to the 2012/13 *Global Competitiveness Report*). The recent legislative amendments improve operational independence of the SMA by allowing parliament on the government's proposal to appoint and discharge the director and council members and extend their term in office from five to six years. However, it is not clear whether the SMA

Figure 1.14. **Public ownership is large and foreign direct investment is low**

Per cent of GDP, 2011




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

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

StatLink http://dx.doi.org/10.1787/888932797233

has the resources and financial independence necessary to carry out its duties, as its supervision fee structure and annual budget plans are subject to government approval, and its employees remain subject to public employment regulations that prevent them from receiving market based salaries. At a practical level, it is worth noting that the authority has only 49 employees spread over eight separate divisions, which would suggest that the depth of its capacity to oversee the market is limited (OECD, 2011a).

The independence of the SMA is further undermined in an environment of state block holders and a substantial number of weak minority shareholders. According to the 2012/13 *Global Competitiveness Report*, Slovenia ranks 127 in terms of protection of minority shareholders' interests. Although the Slovenian legislation is broadly comparable to other OECD countries, *de facto*, the possibility of political interference and limited protection of minority shareholders' interest that are rarely represented in the monitoring boards hinder the development of the stock market. As an example, one should consider Abanka, which requires a capital injection, and its owner Triglav, as both are controlled by the state. From the perspective of private shareholders of Triglav, it might make sense to close Abanka and write-off the losses, because its market value is much smaller than the required recapitalisation. Since both institutions are state-owned, Triglav is going to recapitalise Abanka, irrespective of the interests of private shareholders.

Another important dimension of investor protection is the extent of disclosure about related party transactions. Despite the new legislation regulating the approval of related-party transactions, according to the World Bank *Doing Business* Indicators, Slovenia has an index of 5 on a scale between 0 and 10. The disclosure of related party transactions is particularly important in countries with small populations, explaining why relatively small countries, such as Estonia, New Zealand and Sweden have opted for very high levels of disclosure.

## Preventing future crises

Although banking regulation and supervision is broadly in line with international standards and the Bank of Slovenia has duly transposed EU banking directives and has incorporated many guidelines from the European Banking Authority, there have been weaknesses in the implementation of these standards (IMF, 2012a). Hence, it is important to strengthen banking regulation and supervision within the framework of the EU banking union.

### *Bank supervision should be more transparent and forward-looking*

The root of the crisis is poor credit management by banks and the supervision by the Bank of Slovenia appears retrospectively as having been insufficient to control banks' credit policies, notably the high concentration of risk in the construction sector and financial holdings. Although the supervisor has been requiring banks to strengthen their credit risk management – and had introduced a macro-prudential instrument (extra capital buffer) during the boom years – it has not been successful enough in obtaining significant improvements (IMF, 2012a).

On the micro-prudential supervision side, the supervisor remains quite optimistic about banks' ability to manage credit risk and resolve NPLs by themselves as the Bank of Slovenia seems keener on solving the issue of bad loans by creating specific units within the banks rather than creating a bad bank. The provisioning in Slovenia is done in accordance with International Accounting Standards, which gives the banks the discretion to apply different provisioning methods that are not always comparable. Given poor risk practices of some banks, such discretion is questionable and banks should be required to apply a homogeneous method of provisioning.

The bank of Slovenia should develop on-site examinations of loan portfolios on larger samples and induce banks to take a more conservative stance on collateral valuations (IMF, 2012a). Taking into account the difficulty in improving banks' risk practices and corporate governance, the Bank of Slovenia should be even more conservative and proactive in the future in its provisioning requirements and ensure that other remedial actions are taken in a timely manner. Given the small size of the Slovenian economy and tight interlinkages between banks and firms, the Bank of Slovenia should be especially prudent with provisioning requirements for large and related exposures.

The quality of micro-financial regulation may also suffer from the fact that a number of useful indicators are not collected or the frequency of collection is not sufficient. Reporting of problem assets lacks granularity (IMF, 2012a). Although, the supervisor shares its information on NPLs for private firms, households and, entrepreneurs, the data on NPLs for SOEs is not made available. This is a weakness given the dominance of the state in the economy. Despite a very high share of renegotiated loans, the Bank of Slovenia possesses very little information about the nature of these loans (what share is renegotiated after they are overdue, what share becomes overdue in the future, what is the coverage ratio of renegotiated loans). Data collected on related parties is incomplete (IMF, 2012a). As to frequency of data collection, capital adequacy ratios are only collected quarterly, though this is consistent with EU requirements. The survey that allows having reliable information on overdue loans for households is only annual. Although alternative sources of information are available, the share of NPL is not published on the webpage of the Bank of Slovenia.

More importantly, the quality of banking supervision might be undermined by the dominance of state ownership among banks and enterprises. Even though all banks are subject to the same standards of prudential oversight, in practice regulatory forbearance is likely to be more often applied to SOBs because bank supervisors might prove unable or unwilling to require that SOBs adhere to regulations (Andrews, 2010). Last but not least, the effectiveness of the supervision is likely to be undermined by understaffing of the banking supervisor and, hence, it would be advisable to expand off-site and to a lesser degree on-site staff (IMF, 2012a).

The powers of the Bank of Slovenia to ensure that additional capital is raised by SOBs is limited (IMF, 2012a). *First*, shareholders (which are often the state) have the right not to fulfil the supervisor's requirement to increase capital. *Second*, until recently the supervisor lacked powers to evaluate, license and directly remove unqualified members of the supervisory board. The law providing such powers has been adopted by the parliament in mid-December 2012 and it remains to be seen how it is implemented in practice. This is crucial as, similar to provisioning requirements, the Bank of Slovenia has to become more conservative and proactive in its capital requirements (and more generally in its supervisory duties) if it wants to avoid a repetition of the current banking crisis.

While the Bank of Slovenia has an explicit mandate for financial stability, the only macro-prudential instrument that is currently in use is annual micro and macro stress-tests (the previous capital buffer has been scrapped as the financial crisis unfolds). As mentioned earlier, the results of these tests are not publicly disclosed. The publication of the annual *Financial Stability Review* is commendable, but the Bank of Slovenia has to develop new macro-prudential tools and be more forceful in implementing its own recommendations.

To maintain market discipline, it is important to ensure that unviable banks undergo an orderly resolution. However, the involvement of the Bank of Slovenia in the BAMC appears to be insufficient as it only has a consultative role. New amendments to the Banking Act, passed in mid-December 2012, entrust the Bank of Slovenia with resolution powers, such as the appointment of a bank's extraordinary management board, compulsory disposal of shares of a bank for the account of existing shareholders, the increase in the initial capital and transfer of assets and liabilities of a bank to an acquiring company. The explicit granting of such powers is a welcome step forward. Yet, effectiveness of the law might be limited, because the law does not allow the Bank of Slovenia to implement a bail-in (impose losses on bond holders) and create bridge banks (a temporary bank to administer assets and liabilities of a failed bank). The experience with the BAMC should serve as a learning experience for the use of a bridge bank as a resolution tool in the future. Moreover, the new law does not specify the source of funding arrangements in order to minimise taxpayer's exposure to losses from solvency or liquidity support. Best practices show that such arrangements could be financed by institutions themselves, such as resolution funds already established in Germany and Sweden and funded by levies on banks' assets. Finally, given the likelihood of conflicts of interest, the functional separation of resolution activities from the supervision activities is necessary.

Finally, greater public transparency of the Bank of Slovenia could help reassure financial markets. Currently, the Bank of Slovenia's webpage contains a very limited amount of information on the structure of banks' assets, liabilities, capital, solvency, non-performing loans, liquidity and profitability. The English version of the webpage contains only very aggregated balance sheet data on the banking sector that lacks granularity and does not provide data on profit and loss statements, loan quality or capital adequacy. The Slovenian version provides more information, but it also lacks the degree of granularity necessary for the analysis.

### *Comprehensive credit registry for enterprises is essential for alleviating information asymmetries between firms and banks*

As mentioned earlier, Slovenian firms borrow simultaneously from multiple banks, but in the absence of credit information sharing between banks, this could have been one of the reasons for poor risk management prior to the crisis. A comprehensive credit registry that covers all borrowing firms and provides positive (loan conditions and its repayment) and negative (non-repayment of loans, loan restructuring) information is an important tool for development of sustainable credit markets for a number of reasons. *First*, it attenuates problems of adverse selection for banks allowing them to better evaluate risk and disciplines borrowers that know that their credit history is taken into account in banks' decisions. *Second*, it decreases "hold-up" problems for borrowers who cannot switch banks due to information asymmetries and, thus, are constrained to pay higher interest rates. A well designed credit information sharing scheme has been shown to lower the cost of intermediation and to improve access to credit (Brown et al., 2009). *Finally*, credit registries help supervisors monitor credit risk of individual financial institutions, as well as analyse the stability of the entire financial system, improve policy design, analyse the impact of financial regulations and conduct research.

The Bank of Slovenia established a credit registry in 1993 for supervisory purposes. The reporting is mandatory for all banks that have to report positive and negative information. However, banks do not have the right to access all information stored in this credit registry. While all essential information is shared for existing borrowers, there is no comprehensive access to the credit history of potential borrowers from other banks. The Bank of Slovenia has to be required to share a complete set of information with individual banks to alleviate informational asymmetries between banks and borrowers. The history of the shared information could be limited to five years in order to balance disciplining borrowers and providing them with a second chance. At the same time, borrowers should have the right to verify the correctness of the collected information.

### Box 1.3. **Recommendations to restructure banks and smooth deleveraging of the private sector**

**Cleaning-up banks' balance sheets**

- Conduct and disclose the main results of new bottom-up ("due-diligence") and top-down stress tests of the banking sector, which should be made under conservative and transparent assumptions.
- Strengthen financial independence of the Bank Asset Management Company (BAMC) by providing it with sufficient capital. The non-executive directors of the management board and members of the inter-ministerial committee should meet the same professional requirements as executive directors.

### Box 1.3. **Recommendations to restructure banks and smooth deleveraging of the private sector** *(cont.)*

- Ring-fenced assets should be fully disposed at the end of the mandate of the BAMC and not transferred as currently envisaged to the sovereign holding company to avoid a permanent postponement of the resolution of impaired assets.
- Recapitalise distressed but viable banks, preferably by issuing shares, and wind down non-viable banks. To reduce fiscal costs of bank resolution, holders of subordinated debt and lower-ranked hybrid capital instruments should absorb losses.
- Privatise state-owned banks and do not retain a blocking minority shareholding.

**Simplifying insolvency procedures**

- Encourage distressed firms to apply early for insolvency procedures by a better law enforcement concerning the liability of debtors that fail to apply for insolvency procedures in a timely manner, encouraging balance-sheet insolvent borrowers to apply, and distinguishing between honest and fraudulent bankruptcy.
- Ease restructuring of distressed businesses via simplified fast track in-court reorganisation of small and medium-sized enterprises and establishment of a legal framework for out-of-court restructuring.
- Enforce the existing legislation that limits duration of certain insolvency procedures. Ultimately, the objective is to end all insolvency procedures within one year.

**Preventing future crises via enhanced corporate governance and banking supervision**

- Develop equity markets by eliminating political interference into management of listed companies, improved rights of minority shareholders and enhancing operational and financial independence of the Slovenian Securities Market Authorities.
- Enhance transparency and data disclosure by the Bank of Slovenia and ensure that a complete set of credit information from its credit registry is shared with banks.
- Make banking supervision more conservative and forward-looking by adopting a much more prudent approach to large and related exposures.
- Further improve resolution powers of the Bank of Slovenia by providing it with additional tools (bridge bank and bail-in) and foreseeing a financing arrangement, such as a resolution fund.

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*Chapter 2*

# Restructuring welfare spending

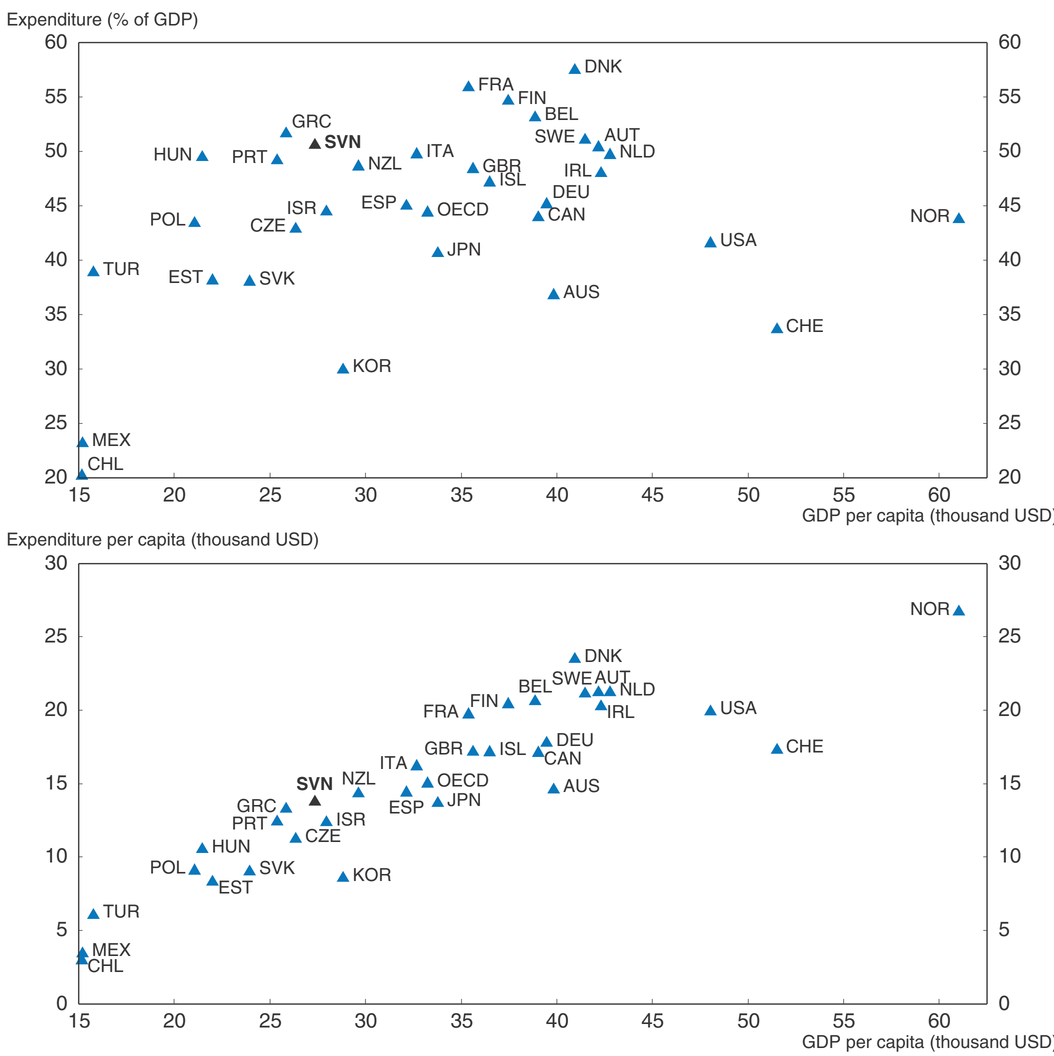
*Restoring fiscal sustainability is a major challenge in Slovenia. Yet, the performance in terms of expenditure control is poor and public expenditure on social spending increased briskly during the crisis, significantly more than on average across the OECD. Despite recent progress in reforming the pension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

## Fiscal sustainability would benefit from a restructuring of welfare spending

Public expenditure as a share of gross domestic product (GDP) is close to 50% in Slovenia and is now the highest among countries with similar levels of economic development (Figure 2.1, Panel A). The level of spending on social transfers and benefits in

Figure 2.1. **Government spending and per capita incomes**[1]

2011[2]




1. Total general government expenditure. Data in US dollars is calculated using current purchasing power parities. The OECD aggregate is an unweighted average of data shown.
2. 2009 for Australia and Chile; 2010 for Canada, Japan, Korea, Mexico, New Zealand and Turkey.

*Source*: OECD (2013), *OECD National Accounts Statistics* (database), February.

StatLink http://dx.doi.org/10.1787/888932797252

kind is close to 20% of GDP, against around 17% for the OECD and other Central and Eastern European countries (CEEC) and 18% for the Nordic countries. Compensation of employees amounts to almost 13% of GDP in comparison with 9% for other CEECs and close to 11% for the OECD. While this situation may reflect social preferences for a well developed welfare state and policies aimed to cushion the impact of the crisis, it has also been driven by poor expenditure control as spending per capita is also sizeable relative to the level of economic development (Figure 2.1, Panel B). With no policy changes, public debt is projected to reach 87% of GDP in 2025 (European Commission, 2012a) and could exceed 100% of GDP when including the costs of rescuing banks. Moreover, Slovenia faces a significant rise in total age-related public expenditure (which includes pensions, health and long-term care) by about 10 percentage points of GDP over the years 2010-60, against around 3 percentage points of GDP for the EU average (European Commission, 2012b), and the recent pension reform will only slightly contain pressure on spending.

Restructuring welfare spending would help to tackle the budget deficit and mitigate further increases in public spending driven by population ageing. Revisiting the welfare state would not induce excessive trade-offs with work incentives and equity objectives. At the same time, it would also expand the elbow room to amend the structure of expenditure in favour of growth-enhancing measures such as productive public investment or spending on active labour market policies.

### *The welfare state is well developed*

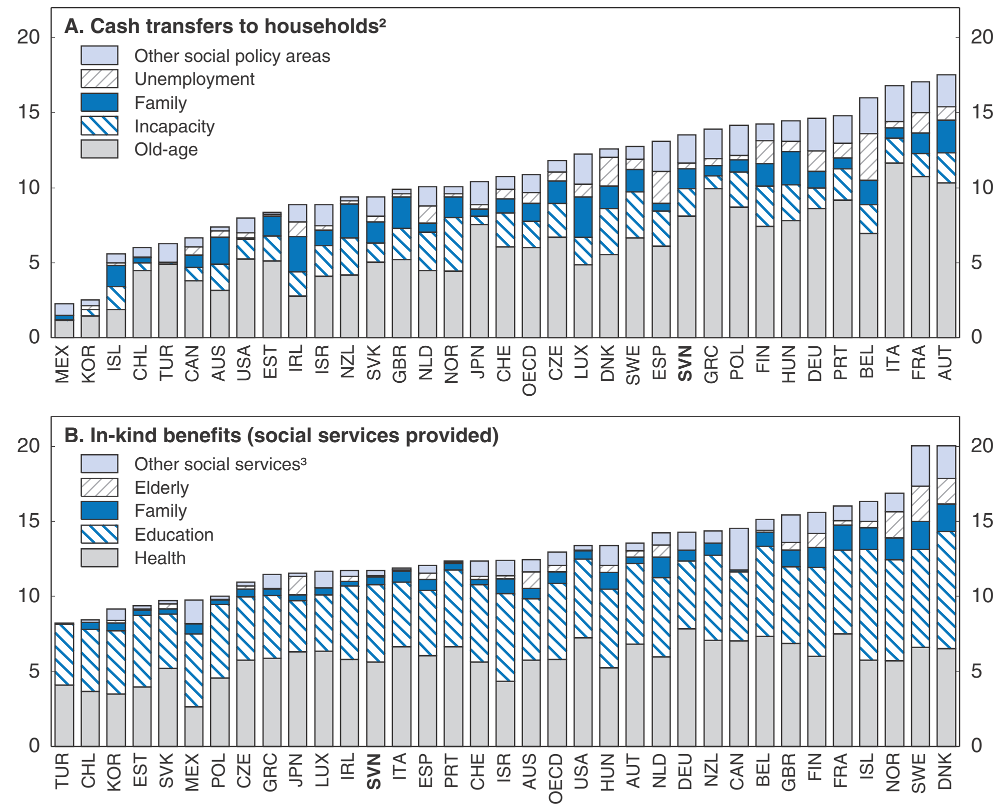
Cash transfers and in-kind (or publicly provided) services or benefits are a significant dimension of the welfare state in Slovenia. Before the global economic and financial crisis, when public spending increased markedly (see below), cash transfers on old-age, family, unemployment, incapacity and other policy areas amounted to 13.5% of GDP against an OECD average of 11% in 2007 (Figure 2.2, Panel A). Pensions accounted for the bulk of total transfers and were two percentage points of GDP higher than the average across the OECD. At the same time, spending as a share of GDP on publicly provided education and health was predominant among in-kind services and very close to the OECD average (Figure 2.2, Panel B). On the other hand, public outlays on family services and other social areas were slightly less generous. Also, in-kind services to the elderly were underdeveloped.

### *Public expenditure has increased briskly during the crisis*

The share of public expenditure in GDP has increased markedly since the beginning of the crisis, worsening fiscal sustainability. General government outlays rose by nearly 8.5 percentage points of GDP during 2007-11, mainly driven by social benefits and transfers in kind, compensation of employees, and other expenditure, while capital expenditures and subsidies were cut (Figure 2.3, Panel A). This contrasts with more contained spending increases as a share of GDP in other OECD countries. In particular, spending on social benefits and transfers in kind increased markedly by 3.5 percentage points of GDP while the corresponding increases in percentage points were 1.5 for other CEEC, 1.9 for the Nordic countries and 2.2 for the OECD on average. At the same time, the increase in the compensation of employees by 2.2 percentage points of GDP was the highest in the OECD. Part of the difference is accounted for by more subdued growth in Slovenia, but it also relates to a poor performance of Slovenia in terms of expenditure control. Indeed, even expressed per capita and at constant purchasing power parities (PPP), the increase in overall government spending has been significantly higher than in Germany and on

Figure 2.2. **Public expenditure on cash transfers to households and in-kind benefits**

Per cent of GDP, 2007[1]




1. Data on education services for Greece, Luxembourg and Turkey refer to 2005. The OECD aggregate is an unweighted average.
2. The data shown exclude private mandatory spending which accounts for an important share of total social spending in some countries (in particular Chile, Germany and Switzerland). In addition, public cash transfers shown here may not fully account for those programmes and services provided, or co-financed, by local governments. Measurement gaps may be high, notably in federal countries such as Canada. Incapacity-related spending covers expenditure on disability pensions and sick leave schemes (occupational injury and other sickness daily allowances).
3. Services to survivors, disabled persons, unemployed, as well as those in respect of housing and social assistance (estimates of social housing are, however, not included).

*Source:* OECD (2012), *OECD Social Expenditure Statistics* (database), November and OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*.

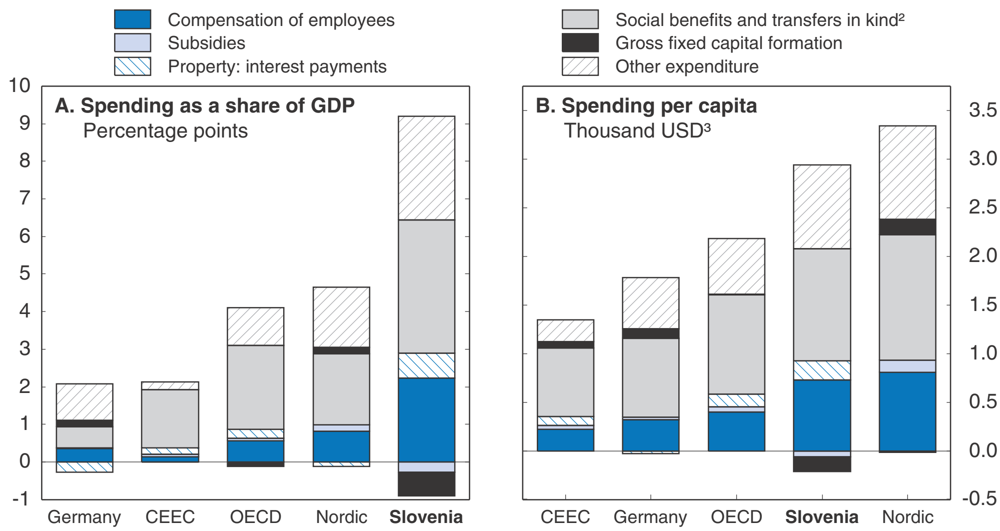
StatLink http://dx.doi.org/10.1787/888932797271

average across the OECD and other CEEC economies since the outset of the crisis (Figure 2.3, Panel B). The rise in the compensation of employees and the decline in gross fixed capital formation were among the highest. This reflects a composition of public spending, which is strongly skewed towards non discretionary components that reduce fiscal flexibility (Mattina and Gunnarsson, 2007).

Recent spending developments in Slovenia contrast with the past experience as growth in expenditure as a share of GDP was tightly under control in the pre-European monetary union (EMU) phase and shrinking in the qualifying period (Figure 2.4). Yet it increased significantly in the wake of the euro area membership, due to offsetting increases in expenditure, and the onset of the crisis which was marked by a deep decline

Figure 2.3. **Evolution of public expenditure by main component**

Change between 2007 and 2011[1]




1. Total general government expenditure. All aggregates are unweighted averages; Central and Eastern European Countries (CEEC) excludes Slovenia. The OECD aggregate excludes Australia and Chile (no data available) and the calculations use estimates for six countries in 2011.
2. For products supplied to households via market suppliers.
3. Using constant purchasing power parities for GDP.

*Source:* OECD (2013), *OECD National Accounts Statistics* (database), February.

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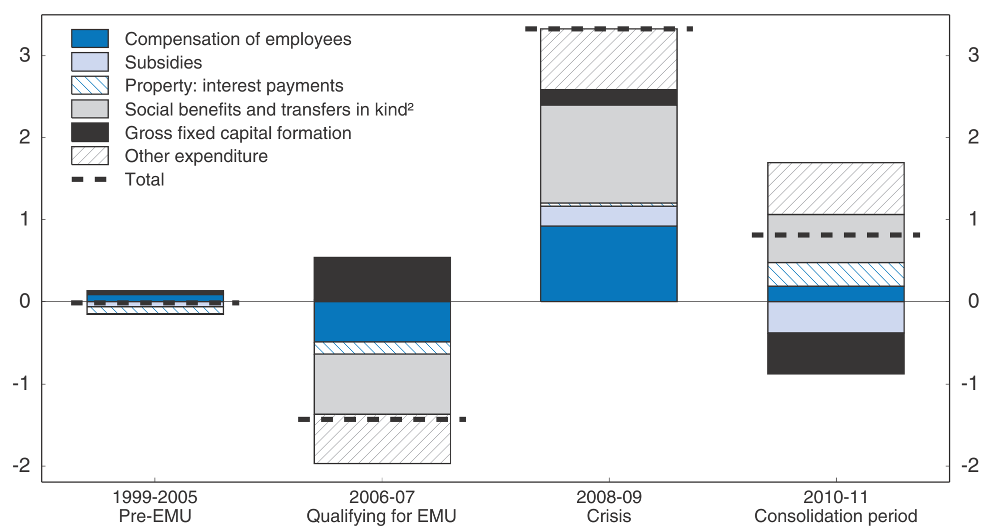
Figure 2.4. **Breakdown of total government expenditure during fiscal policy phases**[1]

Average of annual rates of change over the period, percentage points of GDP




1. Based on national accounts definition. EMU: Economic and Monetary Union.
2. For products supplied to households via market suppliers.

*Source:* OECD (2013), *OECD National Accounts Statistics* (database), February.

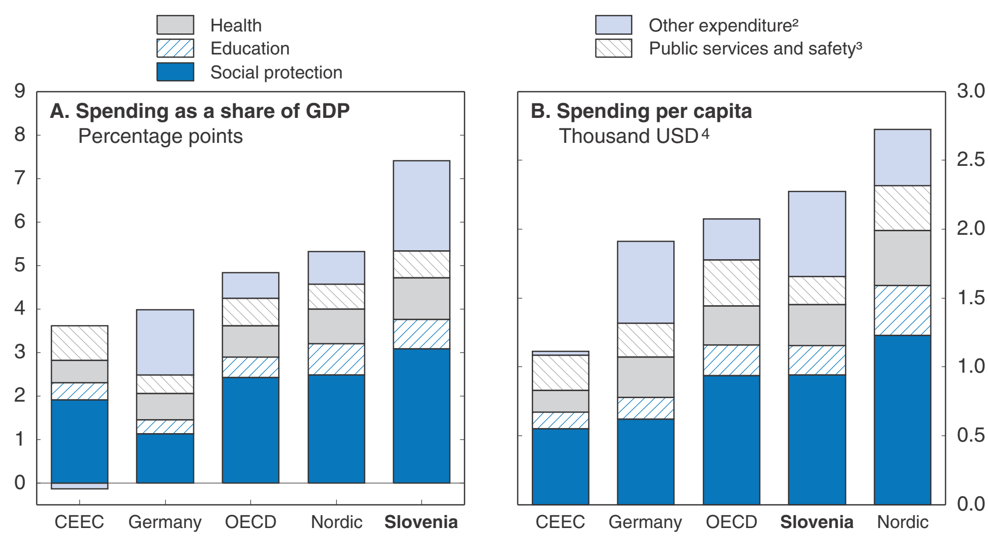
StatLink http://dx.doi.org/10.1787/888932797309

in GDP by almost 8 percentage points in 2009. The share of public spending in GDP continued to grow at a sizeable pace in 2010 and 2011, despite a consolidation programme.

A breakdown of general government expenditure by the main functions shows that, while increases in public spending on public services and safety appeared broadly comparable to other countries between 2007 and 2010 (latest available year), the growth in outlays on other expenditure and on social protection and health was relatively high (Figure 2.5, Panel A). The rise in government expenditure was also significant when considering spending per capita at constant PPP (Figure 2.5, Panel B).

Figure 2.5. **Evolution of public expenditure by main function**

Change between 2007 and 2010[1]




1. Total general government expenditure. All aggregates are unweighted averages; Central and Eastern European Countries (CEEC) excludes Slovenia and OECD excludes Australia, Canada, Chile, Mexico, New Zealand and Switzerland, for which no data are available.
2. Economic affairs; environment protection; housing and community amenities; recreation, culture and religion.
3. General public services, defence, public order and safety.
4. Using constant purchasing power parities for GDP.

*Source:* OECD (2013), *OECD National Accounts Statistics* (database), February.

StatLink http://dx.doi.org/10.1787/888932797328

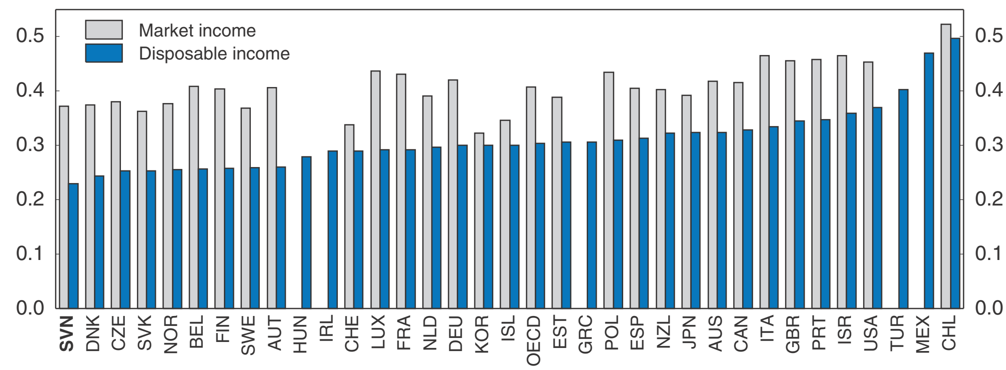
## There is scope to reduce welfare spending while maintaining low inequality

### *Disposable income inequality is the lowest in the OECD*

Slovenia has the lowest disposable income inequality – i.e. the income after taking into account taxes and cash transfers – among OECD countries (Figure 2.6). This indicates a high degree of social cohesion, but also some room for manoeuvre in reducing the size of redistributive policies without leading to an unequal society. In fact, the relative difference between market income and disposable income inequality of the working age population is among the highest in the OECD countries. Yet, even before this sizeable amount of redistribution, Slovenia has one of the lowest levels of income inequality before taxes and cash transfers in the OECD (Figure 2.6). This indicates again scope in reducing the extent of the welfare state without compromising social cohesion. Moreover, recent OECD empirical evidence suggests that in-kind benefits contribute to further diminishing income inequality in Slovenia (OECD, 2011a). In particular, the income-increasing effect of early

Figure 2.6. **Gini coefficients of inequality of market and disposable incomes**[1]

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




1. The Gini coefficient has a range from zero (when everybody has identical incomes) to 1 (when all income goes to only one person). Increasing values of the Gini coefficient thus indicate higher inequality in the distribution of income. Market income includes incomes from wages and salaries, self-employment income and cash property income together with occupational and private pensions. Disposable income is obtained by subtracting income tax and employees' social security contributions from gross income. Both income measures are adjusted to reflect differences in household needs depending on the number of persons in the household.
2. Late 2000s refers to a year between 2006 and 2009. The OECD average excludes Greece, Hungary, Ireland, Mexico and Turkey (no information on market income available).

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

StatLink http://dx.doi.org/10.1787/888932797347

childhood education and care services is large for families with young children, the enrolment rate in public child care of children in lower-income households is relatively high and social housing is strongly targeted to the poorest individuals.

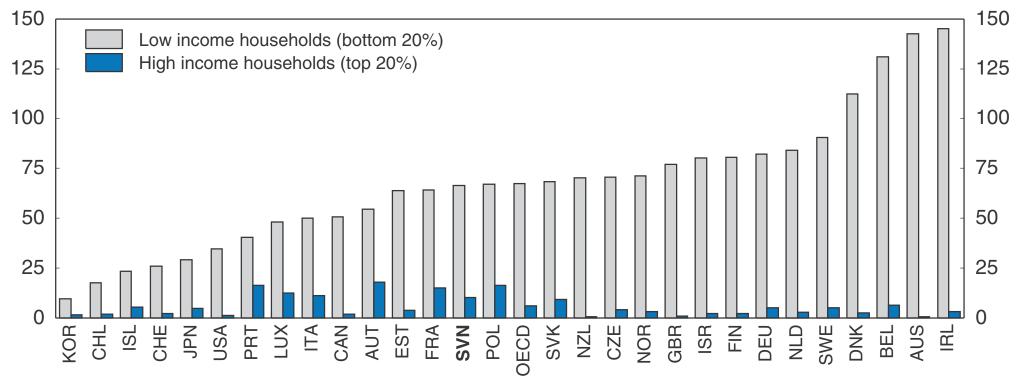
### *Cash transfers and in-kind benefits have a low progressivity*

While the redistributive impact of household taxes is among the highest in the OECD and most of the redistribution occurs on the spending side, that of cash transfers is weakened by their relatively low progressivity (Joumard et al., 2012). The redistributive impact of public cash transfers is close to the OECD average, with their large size offsetting their lower progressivity. Sweden attains a stronger effect on inequality reduction due to higher progressivity of transfers, even though their magnitude is similar to that in Slovenia. Alternatively, Netherlands obtains about the same decrease in income dispersion as Slovenia through a combination of higher progressivity and a lower size of transfers.

The redistributive impact of welfare benefits also depends on their mix, which in Slovenia is skewed towards pensions (Figure 2.2, Panel A). These are less progressive and the dispersion of pension transfers is quite high (Joumard et al., 2012), which is partly due to the characteristics of the pension system as people can retire at the age of 65 with 15 years of contributions only, hence weighing on the adequacy of pensions (see below). On the other hand, the progressivity of unemployment benefits, as measured by the difference in the net replacement for low and high earners (respectively at 67% and 150% of the average wage) is significantly above the OECD average, in particular for families with no children both in the initial phase and after five years of unemployment. Overall, while cash transfers are equivalent to 67% of market income of the poorest 20% in Slovenia, which is comparable to the OECD average, they are equivalent to 10% of high-income earners' market income (and essentially correspond to family benefits), which is quite significant in

Figure 2.7. **Cash benefits received by low and high income households**[1]

Per cent of market income, mid-2000s




1. Households headed by working-age individuals.

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

StatLink http://dx.doi.org/10.1787/888932797366

comparison with other OECD countries (Figure 2.7). Hence, the share of high-income earners eligible for cash transfers could be significantly reduced.

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

Countries with similar levels of expenditure on publicly provided services tend to perform better in reducing inequalities than Slovenia (OECD, 2011a). Various income inequality indicators decrease by about 18% in Slovenia after taking into account in-kind benefits while, for comparable levels of expenditure, their reductions are in the range of 24-33% in Ireland, 18-32% in Italy, 20-25% in Luxembourg or 20-34% in Spain. In particular, the allocation of tertiary education services is very regressive with 35% of tertiary education expenditures going to the top quintile of the income distribution and only 9% to the lowest one. The experience of OECD countries shows that introducing universal tuition fees along with means-tested grants and loans with income-contingent repayments would promote access and equity while sharing the costs of higher education between the state and students (OECD, 2012).

## Improving the design of cash benefits

Despite recent progress, there is still scope to reduce public spending by cutting the combined generosity of cash benefits, such as unemployment benefits, social assistance and other social transfers for the unemployed and inactive persons. This would boost work incentives and even more so if, at low income levels, benefits could be withdrawn at a lower rate than the increase in earnings to allow a net increase in income. However, as such benefit reforms are likely to worsen income distribution, they should continue to be introduced gradually. Indeed, empirical research shows that they can have more favourable employment effects in good times rather in bad times (Bouis et al., 2012). That said, the political economy of reforms suggests that bad times tend to be a major driver of reforms and that such reforms should be legislated soon, even if their actual implementation is somehow delayed.

### *Reducing welfare traps*

The level of average effective tax rates (AETRs) when returning to work from inactivity (or inactivity trap), which measures the proportion of any increase in earnings that is lost through the combined operation of different tax increases and withdrawal of benefits for inactive people no longer eligible for unemployment benefits, is high (Table 2.1; see also Stovicek and Turrini, 2012). For instance, 82% of income is lost is lost due to taxes and reduced benefits when moving from inactivity to employment for households consisting of a one-earner married couple with two children at 67% of average wage. The AETRs in Slovenia are significantly above 50%, except for two-earner married couples with children. They are much higher than in other CEEC economies, but their magnitude is also large in comparison with the OECD average. On the benefit side, they are mainly driven by

Table 2.1. **Inactivity traps in international comparison**

Average effective tax rate when moving from inactivity into work for selected family types and earnings levels, per cent, 2010[1]

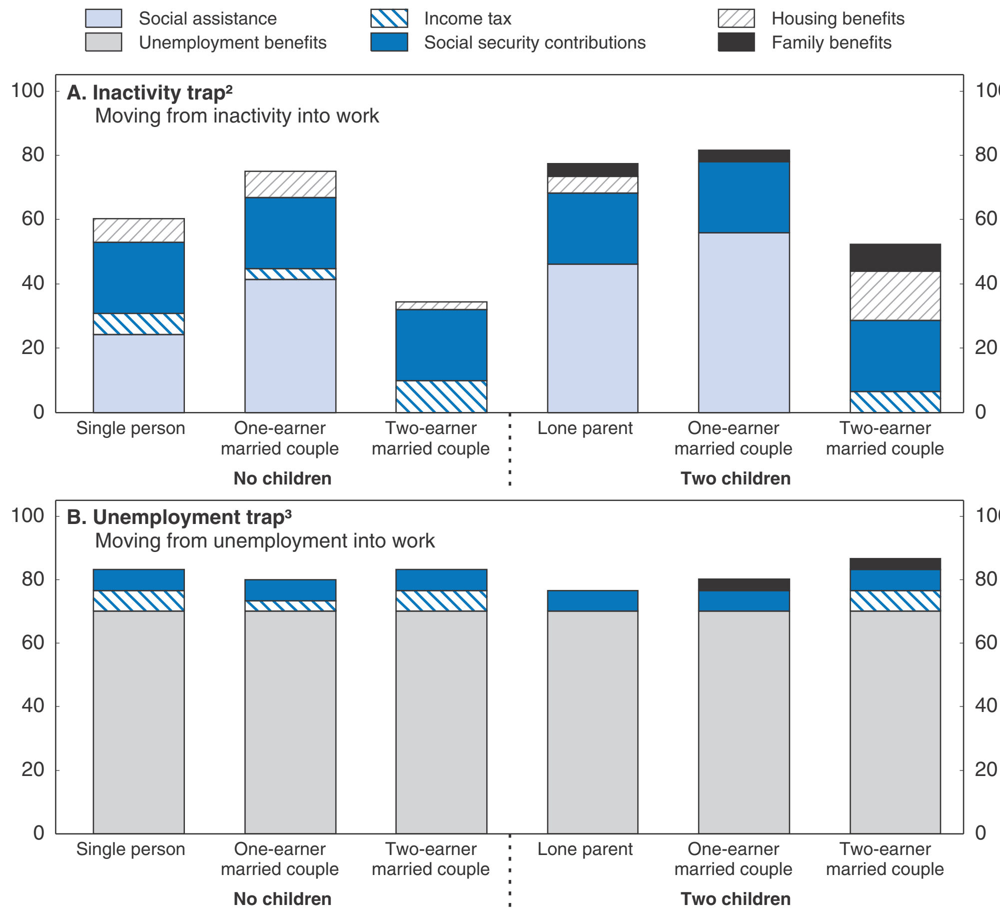
| Family type | Wage level (% of average worker) | **Slovenia** | Germany | Other CEEC[2] | Nordic countries[2] | OECD[2] |
|---|---|---|---|---|---|---|
| One-earner married couple | 67 | **75** | 70 | 54 | 85 | 63 |
| | 100 | **64** | 62 | 45 | 72 | 54 |
| | 150 | **57** | 55 | 42 | 64 | 49 |
| Lone parent with two children | 67 | **77** | 80 | 45 | 68 | 57 |
| | 100 | **76** | 70 | 48 | 63 | 55 |
| | 150 | **67** | 62 | 44 | 59 | 51 |
| One-earner married couple with two children | 67 | **82** | 78 | 57 | 94 | 66 |
| | 100 | **75** | 69 | 49 | 81 | 60 |
| | 150 | **67** | 60 | 45 | 71 | 54 |
| Two-earner married couple with two children | 67 | **52** | 48 | 30 | 40 | 35 |
| | 100 | **49** | 48 | 30 | 39 | 36 |
| | 150 | **48** | 47 | 31 | 42 | 37 |

1. Average effective tax rates measure the extent to which taxes and benefits reduce the financial gain of moving into work. The estimates here relate to the situation of a person who is not entitled to unemployment benefits (e.g. because their entitlements have expired). Instead, social assistance and other means-tested benefits are assumed to be available subject to relevant income conditions. Where receipt of such assistance is subject to activity tests (such as active job-search or being "available" for work), these requirements are assumed to be met in the out-of-work situation. Cash housing benefits are calculated assuming private market rent, plus other charges, amounting to 20% of the full-time wage for all family types. The percentage of average worker (AW) relates to the earnings from full-time employment of the individual moving into work. For married couples the percentage of AW relates to one spouse only; the second spouse is assumed to be inactive with no earnings in a one-earner couple and to have full-time earnings equal to 67% of AW in a two-earner couple. Calculations for families with children assume two children aged 4 and 6, neither childcare benefits nor childcare costs are considered.
2. Unweighted averages, the OECD aggregate excludes Chile and Mexico for which no data are available. CEEC: Central and Eastern European Countries.

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

Figure 2.8. **Inactivity and unemployment traps are large**

Average effective tax rate, 2010[1]




1. Average effective tax rates measure the extent to which taxes and benefits reduce the financial gain of moving into work. The percentage of average worker (AW) relates to the earnings from full-time employment of the individual moving into work based on 67% of the AW level. For married couples the percentage of AW relates to one spouse only; the second spouse is assumed to be inactive with no earnings in a one-earner couple and to have full-time earnings equal to 67% of AW in a two-earner couple. Calculations for families with children assume two children aged 4 and 6; neither childcare benefits nor childcare costs are considered. Any benefits received are subject to relevant income conditions or means-testing.
2. For full details of coverage see footnotes of Table 2.1.
3. Unemployment at the initial level; for full details of coverage see footnotes of Table 2.2.

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

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spending on social assistance and, to a smaller extent, housing and family benefits (Figure 2.8, Panel A).

For people who are also entitled to unemployment benefits, the AETRs measuring their implicit taxation (or unemployment traps) when they return to full-time work are also high in Slovenia (Table 2.2 and Figure 2.8, Panel B). They exceed 70% and tend to increase with income levels. They are systematically higher than in other CEEC countries and the OECD average. On a different measure which does include the impact of taxes, the net replacement rates at the initial phase of unemployment for families that also qualify for additional financial “top ups” appear substantial, often above 80% (Table 2.3). They are

### Table 2.2. **Unemployment traps in international comparison**

Average effective tax rate for a transition into full-time work for persons receiving unemployment benefits at the initial level, for selected family types and earnings levels (same in new job as in previous), per cent, 2010[1]

| Family type | Wage level (% of average worker) | **Slovenia** | Germany | Other CEEC[2] | Nordic countries[2] | OECD[2] |
|---|---|---|---|---|---|---|
| One-earner married couple | 67 | **80** | 69 | 63 | 77 | 70 |
| | 100 | **81** | 73 | 59 | 69 | 65 |
| | 150 | **69** | 74 | 55 | 63 | 59 |
| Lone parent with two children | 67 | **77** | 77 | 69 | 81 | 70 |
| | 100 | **87** | 80 | 69 | 73 | 69 |
| | 150 | **75** | 79 | 61 | 66 | 63 |
| One-earner married couple with two children | 67 | **80** | 74 | 61 | 78 | 69 |
| | 100 | **79** | 77 | 59 | 70 | 67 |
| | 150 | **71** | 78 | 54 | 64 | 61 |
| Two-earner married couple with two children | 67 | **87** | 86 | 69 | 78 | 70 |
| | 100 | **82** | 86 | 64 | 70 | 67 |
| | 150 | **70** | 84 | 58 | 64 | 61 |

1. Average effective tax rates measure the extent to which taxes and benefits reduce the financial gain of moving into work. The estimates here relate to the situation of a person who has just become unemployed and receives unemployment benefits (following any waiting period) based on previous earnings equal to earnings in the new job. No social assistance "top-ups" or cash housing assistance are assumed to be available in either the in-work or out-of-work situation. Any benefits payable on moving into employment are assumed to be paid. The percentage of average worker (AW) relates to the earnings from full-time employment of the individual moving into work. For married couples the percentage of AW relates to one spouse only; the second spouse is assumed to be inactive with no earnings in a one-earner couple and to have full-time earnings equal to 67% of AW in a two-earner couple. Calculations for families with children assume two children aged 4 and 6, neither childcare benefits nor childcare costs are considered.
2. Unweighted averages, the OECD aggregate excludes Chile and Mexico for which no data are available. CEEC: Central and Eastern European Countries.

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

significantly higher than in other countries apart from a few exceptions. The net replacement rates with additional "top ups" drop for long unemployment spells (Table 2.3). Yet their generosity still appears significant for families with children. The duration of unemployment benefits – of up to 25 months – is also relatively generous.

### *Recent reforms of social transfers and subsidies*

Recent reforms of social benefits create a strong potential to boost fiscal savings. Major progress has been achieved with the implementation, since January 2012, of a new electronic system with a central database that allows an efficient income and wealth means testing of social transfers and subsidies, which bodes well for a rationalisation of welfare expenditure (Box 2.1; see also Kump et al., 2011 and Stropnik, 2011). Preliminary results indicate that the system is effective and has lowered eligibility of high-income earners to social transfers through tighter means testing and reduced fraud through better access to information. However, there were plans to increase the minimum income by 25% prior to the implementation of the new system, which is used as a base for social assistance. This would have strained public expenditure and deepened benefit dependency so that eventually the magnitude of the hike was reduced by half.

Fiscal consolidation measures adopted in the first half of 2012 somewhat reduced the generosity of social transfers. Subsidies for school and student meals were lowered, parents were required to cover 30% of childcare costs for the second child, the parental

Table 2.3. **Net replacement rates during unemployment in international comparison**

For selected family types and earnings levels, per cent, 2010[1]

| | Family type | Wage level (% of average worker) | **Slovenia** | Germany | Other CEEC[2] | Nordic countries[2] | OECD[2] |
|---|---|---|---|---|---|---|---|
| **Initial phase of unemployment**[3] | One-earner married couple | 67 | **85** | 61 | 69 | 81 | 74 |
| | | 100 | **74** | 61 | 59 | 64 | 62 |
| | | 150 | **53** | 60 | 49 | 48 | 49 |
| | Lone parent with two children | 67 | **83** | 76 | 79 | 87 | 77 |
| | | 100 | **89** | 72 | 73 | 75 | 71 |
| | | 150 | **68** | 69 | 60 | 59 | 57 |
| | One-earner married couple with two children | 67 | **84** | 77 | 70 | 93 | 78 |
| | | 100 | **89** | 75 | 61 | 76 | 71 |
| | | 150 | **71** | 70 | 52 | 59 | 56 |
| | Two-earner married couple with two children | 67 | **92** | 90 | 85 | 87 | 85 |
| | | 100 | **86** | 88 | 77 | 76 | 77 |
| | | 150 | **71** | 83 | 68 | 64 | 66 |
| **Long-term unemployment**[4] | One-earner married couple | 67 | **67** | 61 | 46 | 71 | 56 |
| | | 100 | **49** | 45 | 32 | 53 | 41 |
| | | 150 | **35** | 31 | 23 | 39 | 29 |
| | Lone parent with two children | 67 | **79** | 76 | 51 | 71 | 59 |
| | | 100 | **70** | 58 | 41 | 59 | 49 |
| | | 150 | **54** | 42 | 29 | 46 | 37 |
| | One-earner married couple with two children | 67 | **84** | 77 | 58 | 85 | 66 |
| | | 100 | **72** | 62 | 44 | 68 | 53 |
| | | 150 | **57** | 45 | 32 | 52 | 40 |
| | Two-earner married couple with two children | 67 | **71** | 65 | 59 | 65 | 62 |
| | | 100 | **60** | 55 | 49 | 54 | 53 |
| | | 150 | **50** | 44 | 39 | 45 | 43 |

1. For married couples the percentage of average worker (AW) relates to the previous earnings of the "unemployed" spouse only; the second spouse is assumed to be "inactive" with no earnings and no recent employment history. Where receipt of social assistance or other minimum-income benefits is subject to activity tests (such as active job-search or being "available" for work), these requirements are assumed to be met. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.
2. Unweighted averages, the OECD aggregate excludes Chile and Mexico for which no data are available.
3. Initial phase of unemployment but following any waiting period. After tax and including unemployment and family benefits; social assistance and other means-tested benefits are assumed to be available subject to relevant income conditions. Housing costs are assumed equal to 20% of AW. Any income taxes payable on unemployment benefits are determined in relation to annualised benefit values (i.e. monthly values multiplied by 12) even if the maximum benefit duration is shorter than 12 months.
4. After tax and including unemployment benefits, social assistance, family and housing benefits in the 60th month of benefit receipt.

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

benefit for child care and nursing was cut, the indexation of child benefits was frozen and eligibility conditions were tightened for higher-income earners. The generosity of unemployment benefits was also somewhat decreased. The replacement rate was reduced from 60% to 50% for spells longer than a year, but left unchanged at 80% for the first three months and 60% for jobless spells between four and twelve months. Also, the ceiling for the highest benefit amount was lowered by 15%.

The unemployment benefit coverage is narrow, with only a third of jobless people receiving unemployment benefits, owing to strict contribution requirements depending on the duration of work experience, which nevertheless have been somewhat relaxed recently. Those excluded get less attention in terms of job counselling and activation, even though they can draw on other substantial forms of income support, in particular social assistance (OECD, 2009a; Stovicek and Turrini, 2012). Beyond streamlining administrative costs and despite the introduction of life-long career guidance in the Employment Service

Box 2.1. **Recent reform of the system of social transfers and subsidies**

A new reform, adopted in July 2010 and implemented since January 2012, introduces major changes in the access to and delivery of means tested social transfers and subsidies. The main objectives of the reform are:

- More transparent, efficient and user-friendly distribution of benefits with the creation of a unified information system, one-stop shops, single application form, and a single decision about all rights.
- Harmonisation of eligibility criteria for four types of social transfers and nine types of subsidies.
- Improved targeting to those most in need of support with means tests for income and wealth.

The reform establishes a priority order for exercising individual rights, while eligibility is conditional on an income threshold including all types of incomes and benefits, except those granted for a special purpose or intended to cover special needs. As a result, the new system prevents an excessive accumulation of benefits. Wealth is also taken into consideration, including the value of immovable property above a certain threshold, vehicles, vessels, bonds, shares, cash, bank deposits, savings on other bank accounts and other types of movable property. It is expected that stricter eligibility conditions and a lower likelihood of fraud through electronic cross-checking of information (with access to more than 40 official databases from 24 institutions) could reduce the number of beneficiaries by 10%. Moreover, the benefit take-up rate could also be lowered because of an old regulation dating back to the 1970s, requiring the repayment of financial assistance after death from inheritance assuming that this does not endanger the social security of heirs, which could now be enforced more strictly.

*Source:* Ministry of Labour, Family and Social Affairs.

of Slovenia and recent coordination progress with the Centres for Social Work, merging the two institutions would create a level playing field between the unemployed and ensure their equal access to active labour market policies. More generally, resources devoted to training and job search services should be sheltered from ongoing fiscal consolidation efforts to support employment and ensure that the long-term unemployed remain attached to the labour market. Indeed, half of the unemployed have been searching for a job for more than a year and there have been growing labour market mismatches.

## Rationalising spending on publicly provided services

In addition to restructuring cash transfers, public spending could be reduced by closing efficiency gaps in the provision of publicly provided services (Box 2.2). There is a significant potential to either strengthen output efficiency (achieve better outcomes for the same level of expenditure) or input efficiency (reduce spending for the same outcomes). The calculation of efficiency frontiers reveals relatively poor scores in comparison with other OECD countries. Slovenia never belongs to the group of best-performing OECD countries and ranks about 25th in terms of output efficiency and 18th to 27th in terms of input efficiency for the three areas of secondary education, health care and public administration.

### Box 2.2. **Efficiency of welfare spending through the lens of efficiency frontier analysis**

The calculation of an efficiency frontier using a cross-country technique called Data Envelopment Analysis (DEA) helps to identify to what extent equivalent outcomes could be achieved with less spending (input efficiency) or, alternatively, better outcomes could be reached with the same level of expenditure (output efficiency). The estimates are derived from model specifications established in earlier OECD empirical studies on health care (OECD, 2010), secondary education (Schwellnus, 2009) and public administration (Forthun and Hagemann, 2010).*

The output efficiency of health expenditure per capita, defined as potential gains in the number of years of life expectancy at birth stemming from a more efficient use of available resources, amounts to around two and a half years. Out of 34 OECD countries, Slovenia ranks 26th and its efficiency score is below the OECD average but higher than for other Central and Eastern European countries (CEEC). However, at broadly similar spending per capita, Slovenia's performance is significantly lower than that of Israel, Korea and New Zealand. Regarding input efficiency, Slovenia is ranked 27th and lags behind the OECD average and countries with comparable living standards, though its score is close to that of the Czech Republic and higher than that for the Slovak Republic. There is scope to reduce health expenditure by nearly 1.5% of GDP in 2020 by exploiting efficiency gains relative to a projected trend increase in expenditure at the same pace as between 2000 and 2010. Put differently, only a 10% increase in spending per capita would be needed from 2010 to 2020 to sustain the same gains in life expectancy as over the previous ten years if potential efficiency gains were to be exploited.

When considering expenditure per capita for the input variable and the average of PISA scores for the outcome variable (PISA: Programme for International Student Assessment), the efficiency of secondary education is significantly lower than in other CEEC countries and below the OECD average both in terms of output and input efficiency. In comparison with 32 OECD countries, Slovenia ranks 26th for the former and 18th for the latter. The country could raise its synthetic PISA score by almost 46 points at the current level of education spending if resources were to be used more efficiently. Alternatively, it could cut spending per student by almost 55% while preserving the same PISA score if efficiency gains were to be reaped.

There are also efficiency gaps in the provision of public administration, defined as spending per capita on general public services and public order and safety, assessed against indicators of the quality of justice, the level of corruption (taken from the *Global Competitiveness Report 2012-2013* [WEF, 2012]), and the level of regulatory burdens (as proxied by the OECD's index of Product Market Regulation). Slovenia's public administration appears to be quite inefficient among OECD countries. Out of a sample of 29 countries, it ranks 24th on output efficiency and 19th on input efficiency. Yet the efficiency scores of some other CEEC countries, for instance the Czech Republic or the Slovak Republic, are even lower. However, caution is needed when interpreting these results as some of the input variables used in the analysis are soft (survey-based) indicators, which can be influenced by cyclical developments among others.

* References: C. Forthun, and R. Hagemann (2010), "Sustaining the Momentum of Fiscal Reform in Hungary", *OECD Economics Department Working Papers*, No. 802; OECD (2010), *Health Care Systems: Efficiency and Policy Settings*; C. Schwellnus (2009), "Achieving Higher Performance: Enhancing Spending Efficiency in Health and Education in Mexico", *OECD Economics Department Working Papers*, No. 732; and WEF (2012), *Global Competitiveness Report 2012-2013*, World Economic Forum.

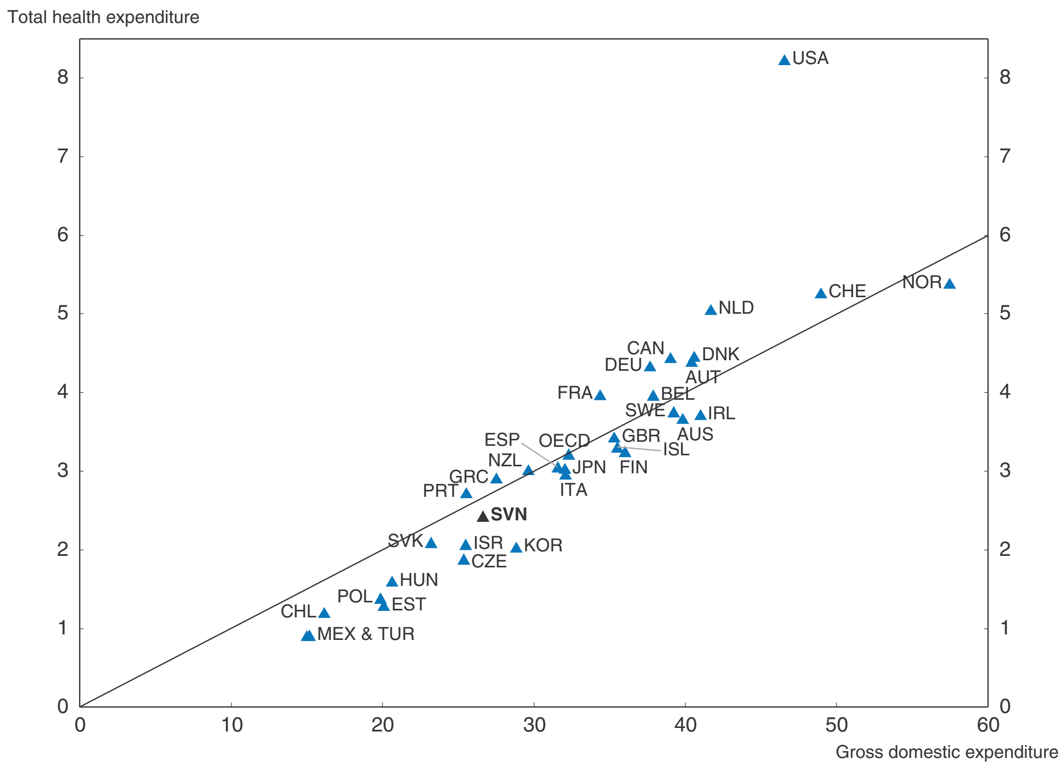
*Source:* M. Hribernik and R. Kierzenkowski (2013), "Assessing the Efficiency of Welfare Expenditure in Slovenia with Data Envelopment Analysis", *OECD Economics Department Working Papers*, forthcoming.

### *Restructuring the healthcare system*

Life expectancy at birth in Slovenia stood at 79.5 years in 2010, almost matching the OECD average. Total health spending is consistent with Slovenia's economic development level (Figure 2.9). It accounted for 9% of GDP in 2010, only slightly lower than the OECD average of 9.5% of GDP. Health spending grew, in real terms per capita, by an average of almost 3.5% per year against an average growth rate in real GDP per capita of close to 2.5% between 2000 and 2010. Yet spending growth was significantly higher in more expensive inpatient care than in less costly outpatient care.

Figure 2.9. **The relationship between health spending and per capita incomes**

Thousand USD per capita, 2010[1]




1. Calculated using current purchasing power parities. 2009 for Australia, Israel and Japan; 2008 for Turkey. The OECD aggregate is an unweighted average of data shown.

*Source:* OECD (2013), *OECD National Accounts Statistics* and *OECD Health Statistics* (databases), February.

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### *Strengthening primary care*

There is evidence of a relatively limited supply of health professionals in Slovenia as reflected by a relatively low number of practising doctors (2.4, against an OECD average of 3.1, per 1 000 population), practising nurses (8.2, against an OECD average of 8.7, per 1 000 population) and one of the lowest ratios of midwives in the OECD (8.7, against 69.8, per 100 000 women on average in the OECD). At the same time, the utilisation of the healthcare system in Slovenia is close to the OECD average as gauged by the number of doctor consultations per capita, though it is slightly higher as measured by hospital discharge rates.

The cost effectiveness of generalist-provided primary care is widely recognised, but the allocation of resources is skewed to more costly specialist care. General practitioners (GPs) represent close to 20% of total doctors in Slovenia, while specialists account for more than 70% (other doctors explain the remainder). The corresponding shares are around 25% for GPs and 58% for specialists in the OECD. As a result, some prevention programmes do not seem to be covered well, despite welcome plans to expand group practices at the primary care level ("reference outpatient clinics") that allow GPs to delegate some tasks to nurses. For instance, screening rates for some types of cancer and influenza vaccination coverage for people above 65 are low by international comparison. Diabetes prevalence is above the OECD average and there is also room to reduce expensive diabetes hospital admission rates.

An increase in the supply of primary-care doctors would provide scope to strengthen their gate-keeping role and cost-effective prevention in the medium term, though this strategy could boost spending in the short term. Easing the criteria allowing foreign doctors to practice in Slovenia might be one option. In 2011, a shortening of lengthy procedures of recognition of foreign diplomas by about two years was a step in the right direction. Other constraints such as specialty examinations, compulsory internships and, for non-EU candidates, language requirements, would need to be relaxed as well. Another possibility is to improve retention, in particular through better management policies and delayed retirement (OECD, 2008). The authorities should also continue to expand the capacity of medical faculties, set higher quotas for medical students and strive to steer students to disciplines with shortages, such as general practice. Finally, reforming the payment system of GPs by introducing an element of pay-for-performance in the current mixed system of capitation and fee-for-service, would ensure attractive salaries for best performing doctors and provide incentives to a better use of existing capacity. This would encourage expenditure reallocation away from higher levels of care in the medium term.

### *Rationalising inpatient care*

A third of overall healthcare spending is on inpatient care, slightly above the OECD average of 29%. Overall amenable mortality, which refers to premature deaths that should not occur in the presence of effective and timely care, is just below the OECD average (Gay et al., 2011). With this as a background, there are areas where quality of care in hospital could be improved. The in-hospital case fatality following ischemic and haemorrhagic strokes is one of the highest in the OECD. Screening coverage and survival rates are relatively low for breast and colorectal cancers. Slovenia has also relatively high mortality rates for lung and prostate cancers. At the same time, the penetration of high-technology medical equipment (such as magnetic resonance imaging units and computed tomography scanners) is low. Developing health technology assessment, which is performed at a very basic level, would ensure a cost-effective diffusion and use of medical equipment.

There is scope to improve efficiency in the utilisation of resources allocated to the hospital sector. The number of hospital beds in acute care could be lowered, as occupancy and turnover rates are relatively low, pointing to excess capacity in inpatient care. Indeed, there is room to increase specialisation and adjust the size of hospitals to the needs of individual regions (Ministry of Health, 2011a). The average length of stay in hospital for all causes is shorter than on average across OECD countries, but could still be reduced for some diagnostic categories, such as tuberculosis or diseases of the pancreas (Table 2.4).

**Table 2.4. Average length of stay in inpatient and acute care for selected diagnostic categories**

Number of days, 2010

| | Slovenia | OECD[1] | Gap (OECD-SVN) |
|---|---|---|---|
| Inpatient care | 6.7 | 8.8 | 2.1 |
| Acute care | 5.4 | 6.2 | 0.8 |
| All causes | 6.3 | 7.0 | 0.7 |
| **Diagnostic categories where improvements are possible** | | | |
| Paralytic ileus and intestinal obstruction without hernia | 13.5 | 8.4 | -5.1 |
| Tuberculosis | 29.7 | 24.9 | -4.8 |
| Complications of surgical and medical care, n.e.c. | 12.7 | 9.3 | -3.4 |
| Malignant neoplasm of ovary | 11.7 | 8.4 | -3.3 |
| Diseases of pancreas | 11.8 | 8.6 | -3.2 |
| Pulmonary heart disease and diseases of pulmonary circulation | 11.9 | 9.2 | -2.7 |
| Peptic ulcer | 10.2 | 7.6 | -2.6 |
| Disorders of teeth and supporting structures | 5.7 | 3.2 | -2.5 |
| Other diseases of the digestive system | 9.3 | 7.2 | -2.1 |

1. The OECD aggregate is an unweighted average of data available and covers 26 countries for inpatient care, 24 for acute care and 21 or 22 countries for all other categories.

*Source:* OECD (2012), "OECD Health Data: Health care utilisation", *OECD Health Statistics* (database).

Various efficiency gaps could be tackled by fully phasing in by 2014 the review of the payment per case system based on diagnosis-related groups for acute inpatient care services that has started in 2013. This system, borrowed from the Australian public sector established in the early 2000s, assigns patients into clinically and economically homogenous groups and specifies associated treatment protocols and price schedules. Yet it was neither adapted to the Slovenian case nor updated with new treatment methods prior to the recent amendments, which had been reducing cost efficiency and transparency of the overall system. Indeed, costs could have been recognised arbitrarily and different fees could have been applied for the same diagnosis-related groups in various hospitals (Albreht et al., 2009).

Finally, more effort is needed to promote ambulatory care. For example, the share of cataract surgeries carried out as day cases in Slovenia was only around 7% in 2010, compared to over 95% in many other OECD countries (including Denmark, Estonia, Finland, Spain, Sweden and United Kingdom). Only around 8% of surgical procedures for inguinal and femoral hernia were carried out on a same-day basis, against more than 50% for best-performing OECD countries. However, latest government data suggest significant improvements in the share of surgeries carried out as day cases, with those for cataract at 98% in 2011.

### *Reforming the financing of health care*

Ageing, higher incomes and cost-increasing technological progress will increasingly strain government budgets. The public sector is the main source of health funding. In 2010, nearly 73% of health expenditure was funded by public sources (mainly stemming from contributions to compulsory health insurance), which was around 0.5 percentage point higher than the OECD average. Additional financing of the health system in Slovenia was derived from private voluntary health insurance and out-of-pocket payments, with respective shares in total health expenditure of around 12.5% and 13%.

The Health Insurance Institute of Slovenia (HIIS) is a single provider of compulsory health insurance and ensures a universal health coverage. However, the system does not cover the full price of all health services and requires co-payments, for instance ranging from about 5% for the most demanding surgical interventions, to 25% for most hospital services, and up to 90% for some medicines. Cost sharing is either through out-of-pocket payments or from voluntary complementary private insurance. The insurance guarantees full co-payment coverage (for all services covered by compulsory health insurance) and almost 95% of the population subscribes. To avoid cream skimming compensating for differences in risk structure between private insurers, a risk-equalisation scheme was implemented in 2005 based on open enrolment and equal risk premiums, irrespective of individual age, gender and health status.

Private complementary health insurance needs to be reformed to be made more sustainable. The system is voluntary, subscribed by almost 95% of individuals and based on a risk-equalisation scheme to avoid cream skimming compensating for differences in risk structure between private insurers. In 2011, the previous government proposed to abolish the complementary health insurance and beef up the compulsory part, to be paid for by an increase in employees' social security contributions (Ministry of Health, 2011a). These proposals were not implemented, but were motivated by the lack of progressivity (premiums are flat); adverse incentives for providers to boost unnecessary demand combined with a low cost awareness of users (the coverage of co-payments is full); positive externalities for insurers from lower prices of health services negotiated by the HIIS; overall cost of operating the system (a fraction of premiums is used for administrative expenses and profits); and a high level of regulation hindering access of foreign insurance companies to the Slovenian market (which led to a referral of the case to the European Court of Justice).

There is no one health system that performs systematically best in improving the population health status in a cost-effective manner, and therefore a "big bang" approach may not necessarily improve efficiency (OECD, 2010a). Rather, it is how a given system is managed that counts (OECD, 2010b). With this as a background, there are options to reform the complementary health insurance instead of abolishing it. As complementary insurance premiums are flat irrespective of age, this puts the financial situation of the complementary health insurance industry at risk as population ages, potentially leading to insufficient coverage. This problem could be tackled by allowing premium differentiation by age as adopted in a number of countries (OECD, 2004; Thomson and Mossialos, 2009, Table 6). Besides, introducing a fee for some health services, which could not be covered and reimbursed by complementary insurance, would prevent unnecessary care and represent a supplementary tool for cost control for the public purse. There is scope to increase out-of-pocket health expenditure in Slovenia as its burden amounts to slightly above 2% of final household consumption, and is one percentage point lower than the OECD average (OECD, 2011b). Concerns over rising inequalities in access to care could be addressed by differentiating co-payments according to income levels while ensuring full co-payment coverage for chronically ill people.

Efficiency gains could be obtained in the medium term by involving insurance companies along with the HIIS in the purchasing process of health services. Today, the insurers do not commission services from providers but merely reimburse their clients (Albreht and Klazinga, 2010). Authorising selective contracting, cancelling obligations to contract with all providers, or creating incentives for involvement in preventive care would represent additional policy levers to foster cost-control efforts of insurers. This could promote greater integration of providers within a single organisation, such as the health maintenance organisations in the United States, and thus allow more cost-effective coordination of care (OECD, 2009b).

### *Reviewing compulsory health insurance*

A reform of compulsory health insurance is also needed to absorb future strains on public expenditure and prevent the practice of shifting a growing part of the burden of paying for health care onto complementary insurers. This is also a concern in a period of economic downturn and lower cyclical payroll contributions while the HIIS is subject to a balanced budget constraint. There is room to rationalise the public benefit basket by reducing the reimbursement rate or delisting certain less medically necessary services, such as spa treatments, non-emergency ambulance transportation or less clinically effective medicines. Moreover, charging working students (as was planned in the mini jobs legislation rejected by referendum in 2011) as discussed in the education chapter in the 2011 *Economic Survey* of Slovenia (OECD, 2011c) and increasing the contribution rate of pensioners would broaden the tax base and increase resources. While the contribution rate for health insurance of employees is 13.45% of their gross income, with 7.09% contributed by employers and 6.36% by employees, pensioners are subject to a rate of only 5.96% of their gross pension.

There is also scope to reduce the expenditure on pharmaceuticals and the authorities have implemented some measures and are considering further cost-cutting in this area (Ministry of Health, 2011b). These notably include reductions in the prices of original (branded) pharmaceuticals negotiated by the HIIS with producers, tighter reference prices for mutually interchangeable medicines, unification of the prices for generics and original pharmaceuticals with expired patent protection, unification of inpatient and outpatient pharmaceuticals, and stricter supervision of advertising.

Slovenia allocates more than 4% of its total health expenditure on administration and operation of health insurance funds, which is above the OECD average of 3%. While higher costs could be partly due to a multi-payer insurance model, when compared to countries with similar institutions, they are lower than in Belgium (5%), or France and the United States (7%), but higher than in Australia and Canada (less than 4%). Indeed, the administrative and management costs could be reduced by avoiding mixing the financing of secondary and tertiary activities, permitting a greater autonomy in resource management of public healthcare providers, and rationalising the number of branch offices of the HIIS (Ministry of Health, 2011b).

### *Rationalising education*

Despite relatively good educational outcomes and the capacity of the Slovenian education system to equip the labour force with relevant skills, there is significant scope for a more efficient use of public resources. Recent plans of the authorities to reform the education system go some way towards the policy priorities identified in the education chapter in the 2011 *Economic Survey* of Slovenia (OECD, 2011c; Republic of Slovenia, 2012a,b).

### *Streamlining pre-school and compulsory education*

The costs of providing early childhood education and care are high, notably due to low child-teacher ratios, while there is excess demand in smaller towns. Moreover, average class size in primary and lower secondary education is low and the ratio of students to teaching staff are below the OECD average in pre-primary and lower secondary education (OECD, 2012). Empirical analysis suggests that raising pupil-teacher ratios and increasing class sizes would not negatively affect the quality or undermine the performance of compulsory education (Sutherland and Price, 2007). To this end, some of the schools and school districts need to be merged and the schools linked into clusters. This would allow a more effective use of staff, but could also increase population density in some areas. The authorities considered increasing teaching obligations and setting up unified school districts along with the adoption of a floor for the minimum number of pupils in a classroom. This would have led to lower costs due to a merger of some schools.

However, the reform proposals have met with strong opposition from teachers' trade unions, who expressed fears that such changes could undermine the quality of the education system and threatened to challenge the proposals in a referendum. This could have blocked the introduction of broader fiscal consolidation measures in mid-2012. Therefore, even though some schools have been merged, the implementation of the planned rationalisation steps had been largely postponed and, more recently, officially suspended.

#### *Boosting the efficiency of tertiary education*

Additional efficiency gains could stem from measures affecting higher education, all the more so as resources devoted to higher education, as measured by spending per student, are relatively low by international comparison. The combination of low student fees, access to generous subsidies and benefits, and preferential tax and regulatory treatment of student work lead to low completion rates and excessively long effective study durations (close to six years on average at the undergraduate level in 2011). Making eligibility to in-study benefits conditional on adequate progress of studies and introducing universal tuition fees along with means-tested grants and loans with income-contingent repayment would improve spending efficiency and tackle biased incentives to remain in the education system for too long.

The authorities plan to cancel the financing of student repetition and, more generally, make the funding conditional on effective enrolment and completion rates. There are also plans to shorten the excessive average duration of studies by eliminating a so-called one year period of graduation preparation in the first cycle of studies (undergraduate three years) to complete missing examinations. On the other hand, a law that would have reduced the attractiveness of student work (OECD, 2011c) was rejected by referendum in April 2011, though a related compulsory fee paid by employers was hiked from 14% to 25% in 2012 and the generosity of tax allowances granted to students has been cut by a quarter. Another law, adopted in May 2011, permits recovery of part of costs from students who extend their studies beyond normal study durations.

## Containing pressures on future public expenditure

### *Overhauling the pension system*

#### *The pension system is unsustainable*

Slovenia has one of the least sustainable pension systems in the OECD, reflecting a combination of pension generosity and population ageing as assessed in the 2009 and 2011 *Economic Surveys* of Slovenia (OECD, 2009c; 2011c). The share of public pension expenditure is currently around 11% of GDP and, prior to the adoption of the recent pension reform, was projected to rise by slightly more than seven percentage points of GDP by 2060, with most of the change likely to occur after 2030 (European Commission, 2012b). The effective retirement age is low, at nearly 62 for men and 58½ for women against an OECD average of close to 64 and 62½, respectively. The old-age dependency ratio, the ratio of people aged 65 and over to the population aged 20-64, is projected to increase from 26% in 2010 to 63% in 2060. At the same time, the working-age population (aged 15 to 64) as a share of total population is projected to fall by almost 15 percentage points by 2060, compared with a drop of nearly 11 percentage points for the European Union as a whole.

A parametric reform of the first (defined benefit) pension pillar was prepared by the previous government, and adopted by parliament, but voted down in June 2011 in a referendum. As discussed in the 2011 *Economic Survey* of Slovenia (OECD, 2011c), the aim was to increase the statutory retirement age to 65 and the minimum retirement age to 60 for both men and women, boost financial incentives to work longer, lengthen the period for the calculation of the pension base, and introduce a partial indexation of pensions to inflation (and not only to wage growth). However, despite being a step in the right direction, the budgetary impact of the reform would have been insufficient to put long-term public finances on a sustainable footing. Indeed, the reform would have mainly postponed the projected rise in public expenditure by around seven years and reduced its expected increase by approximately 2.5 percentage points of GDP by 2060.

Using the 2011 failed pension reform as a starting point, the current government negotiated with social partners and successfully adopted a new reform of the first pillar in December 2012. The main differences with the previous reform include a somewhat longer minimum insurance period (40 years instead of 38) for women to retire at the age of 60, tighter conditions to get a full pension with 40 years of contributions, slightly lower accrual rates, and a less generous indexation of pensions with a higher weight of inflation (40% instead of 30%) and a correspondingly lower weight of wage growth. On the other hand, the pension base was less extended than foreseen in 2011 – raising from 18 to 24 (instead of 27) best consecutive years of contributions. Overall, the effective retirement age is expected to rise by close to two and a half years to 62 for women and by around nine months to 63 for men by 2020. However, the reform will stabilise public spending on pensions as a share of GDP (at around 11%) only until 2020, with the ratio projected to increase thereafter by 5 to 6 percentage points of GDP by 2060.

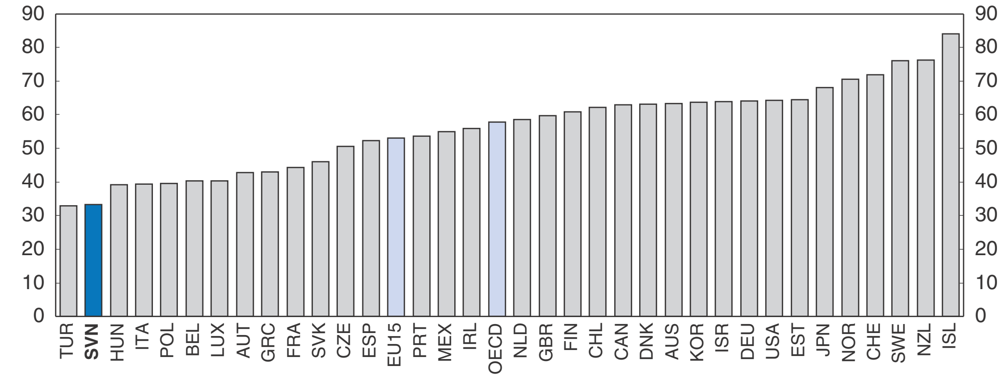
### *Additional reforms are needed*

A new reform package with more comprehensive measures is required to significantly cut the long-term financing needs and raise the second lowest labour force participation rate of older workers in the OECD (Figure 2.10). This can be done by raising the pension eligibility age (both statutory and minimum) and required contributory periods, and indexing further increases in pension parameters to gains in life expectancy. For instance, with a legal retirement age at 65 in 2020, projected life expectancy at 65 would widen by about four years until 2060 (European Commission, 2012b). In this perspective, it is unfortunate that public sector employees who reached the statutory retirement age were requested to retire as part of the fiscal consolidation programme implemented in mid-2012.

Longer work activity could also be favoured by reducing the implicit tax on continued work at older ages (Figure 2.11). The penalty (bonus) for early (deferred) retirement of 3.6%

Figure 2.10. **Labour force participation rate of older workers is low**

Per cent, age 55-64, 2011



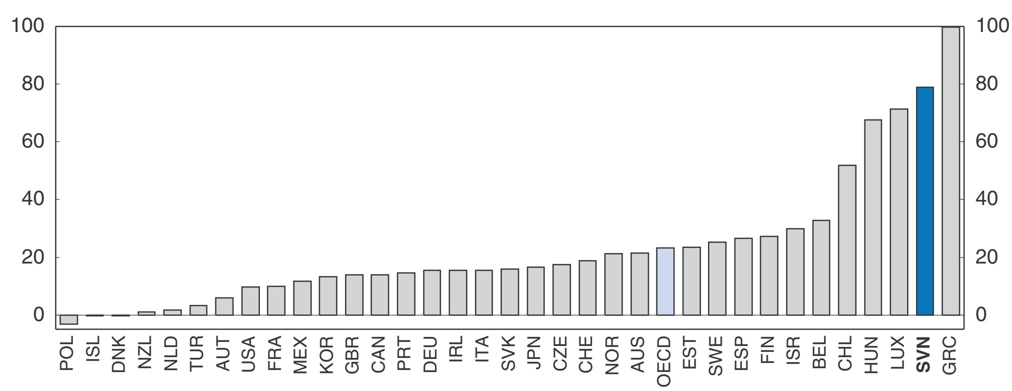

*Source:* OECD (2013), *OECD Employment and Labour Market Statistics* (database), March.

StatLink http://dx.doi.org/10.1787/888932797423

(4%) per year pencilled in to the recent pension reform may encourage workers to retire early as it is below the actuarially neutral level of around 6-8% estimated for OECD countries (Queisser and Whitehouse, 2006). Recent amendments of the pension system have cut early retirement options, though they also allow for lowering the retirement age depending on the number of children (by 6 months for one child, 16 months for two children, 26 months for three, 36 months for four, and 48 months for five or more children), military service and early career starts. Conditions to retire early could also be tightened for numerous special pension regimes (policemen, firemen, pilots, miners, etc.). More generally, reducing the gap between the statutory (full pension) and minimum (partial pension) retirement ages would influence the actual behaviour of labour supply and demand through stronger incentives for life-long learning or better social perception of work capability at older ages.

Figure 2.11. **Implicit tax on continued work at older ages**[1]

Per cent of average worker earnings, 2009[2]




1. Implicit tax on continued work in regular old-age pension system, for 60 year-olds. For methodology see R. Duval (2003), "The Retirement Effects of Old-Age Pension and Early Retirement Schemes in OECD Countries", *OECD Economics Department Working Papers*, No. 370.
2. 2010 for France.

*Source:* OECD (2013), *Economic Policy Reforms 2013: Going for Growth.*

StatLink http://dx.doi.org/10.1787/888932797442

The authorities could also consider further diminishing the generosity of the net replacement rate. Once the new pension reform is fully phased in the benefit ratio for 40 years of contributions is expected to reach 59% of the pension rating base, for men and women respectively. Pensioners in Slovenia are also entitled to family allowances and those above 65 are eligible for a seniority allowance (OECD, 2011d), which may significantly increase their replacement rate. Further extending the base period for the calculation of the pension rating base would lead to a reduction in the replacement rate and many OECD countries are moving to a lifetime concept to assess pensions. Moreover, effective accrual rates could be cut by lowering rates at which benefits accrue and/or diminishing the adjustment of past earnings to the time of retirement for changes in standards of living. For instance, in Belgium, France, and Spain past earnings are valorised in line with prices rather than average-earnings growth, while Finland and Portugal use a mix of prices and earnings.

Benefit indexation rules could be further reviewed by shifting to a combination of prices and wages with equal weights (as, for example, in Estonia, Hungary, Slovak Republic and Switzerland) or taking into account only the effect of prices (as, for instance, in France, Japan, Spain, United Kingdom or United States). The generosity of indexation has been challenged by the crisis. It was reduced to half and a quarter of nominal wage growth in 2010 and 2011, respectively. The indexation of pensions was frozen in 2012 and, as part of fiscal consolidation, only a 0.1% increase is foreseen in 2013.

Ensuring pension adequacy for the most vulnerable is another challenge. Old-age poverty rates are close to 20% in Slovenia, partly as a result of a low average insurance period of 32 years to get a pension, with a minimum of 15 years of contributions to retire at the age of 65. This calls for beefing up social-assistance for low-income pensioners before pension adequacy increases with the recommended raise in the minimum insurance period to receive a pension. The recent creation of a consultative pension register should enhance transparency of accrued pension rights and help reduce poverty risks in retirement.

### *Enhancing long-term care*

#### *Spending on long-term care is low but likely to increase significantly*

At close to 1.3% of GDP in 2010, total spending on long-term care (LTC) in Slovenia is below the OECD average of 1.5% of GDP. The public share is predominant and private spending on LTC accounts for around 0.3% of GDP, as much as across the OECD. Almost 5% of the population over the age of 65 receive LTC in the institutional sector and, as in many other OECD countries, the majority of LTC cost originates from that setting.

LTC still accounts for a relatively small share of GDP compared with age-related spending on health and pensions, but population ageing is likely to put pressure for further public spending on LTC. The greater longevity of individuals can be expected to increase the number of severely disabled. The share of people aged 80 and over will triple to reach 12% in Slovenia and become one of the highest across the OECD by 2050 (Colombo et al., 2011). As in other OECD countries, demand for LTC services is also likely to increase because of declining family size and ties, growing participation of women in the formal labour market, and rising incomes. The latter factor should stimulate demand for better quality and technologically more sophisticated LTC services. In parallel, the ageing process should push up wage costs by reducing the potential supply of formal and informal carers as the working age population is projected to shrink by 20% in Slovenia by 2060 (European Commission, 2012b). Overall, public LTC as a share of GDP is projected to at least double by 2060, according to the European Commission.

### *Reorganising long-term care and developing financing models is necessary*

As in many OECD countries, LTC is a fragmented sector in Slovenia. There are many stakeholders involved in the provision, management and organisation of LTC and several social security laws regulate the sector. LTC in Slovenia is targeted to people over 65, the disabled and the chronically ill. It is based on non-income-tested cash benefits and income-tested benefits in kind (the former cannot be chosen in lieu of the latter by care recipients), provided by health care and/or social services in the form of residential or home care. Cash benefits and residential care are organised centrally while home care services are provided on a local level. Overall, the current system of LTC appears complex and fragmented, with weak coordination between different services, and is insufficiently developed to meet actual and future needs (Prevolnik Rupel et al., 2010).

A new reform has been in preparation since 2005, but has still not been adopted. The objective is to combine LTC services and benefits in an integrated system (by introducing case managers and individual plans and rights for LTC users), put a greater emphasis on the development of home care, and establish new forms of financing LTC. The funding issue has been debated as regards the appropriate tax base for public LTC insurance and the opportunity to create an additional private insurance (Dominkuš and Gracar, 2011). Slovenia does not have a specific LTC funding system: social security contributions on health, pension and disability represent the major source of public funding, complemented by general tax revenues and a local tax for care for disabilities.

For the provision and financing of LTC, Slovenia could look to the experience of other OECD countries (Colombo et al., 2011). Uncertainty concerning the need for LTC services suggests that pooling related financial risks is more efficient in ensuring high and equitable access to care than relying solely on out-of-pocket payments. There has been convergence in the OECD towards adopting a collectively financed system that provides a universal eligibility for a basic package of care, though with differences regarding its generosity (Colombo et al., 2011). However, even in universal systems it is desirable to take into account the individual's ability to pay through income and/or asset means tests and target care benefits to those with the greatest needs.

In Slovenia, such a system of "targeted universalism" could be financed with compulsory public insurance, with contributions levied on the working-age population and retirees, as implemented in Germany and currently planned by the authorities. The levy is expected to combine current sources of financing of LTC, which would increase the transparency of the new system. By extending the tax base beyond the working-age population in the face of population ageing, this would mitigate the increase in labour costs, better pool financing across generations, and ensure funding stability. Increasing user cost-sharing for LTC would also help to contain public spending and mitigate moral hazard risk. For instance, users should be charged for the cost of board and lodging in nursing homes by drawing on accumulated savings and personal wealth, as otherwise they may prefer institutionalisation over receiving care at home.

Developing private LTC insurance would also alleviate pressure on public expenditure, but insurance market failures linked to asymmetric information and consumer's difficulty in forward planning are an obstacle. Automatically enrolling people in voluntary funding schemes with opting-out options as in Singapore would be an innovative solution (Colombo et al., 2011). Alternatively, private LTC insurance could also be made fully compulsory (Dominkuš and Gracar, 2011). Such a system, currently considered by the authorities, could be quickly introduced in Slovenia due to the potential synergies with the widespread availability of voluntary private health insurance.

### *Developing home care to mitigate growing cost pressure*

Seeking better value for money could mitigate pressure on LTC expenditure. Encouraging home and community care, which also has the advantage of being preferred by users, is key. Incentives to use home care in Slovenia are distorted by higher user cost-sharing and lower rights for services than in institutional settings (Prevolnik Rupel et al., 2010). Creating a level playing field for accessibility to health services is thus necessary. Tighter regulations for admissions to institutional care, for instance as introduced in the Czech Republic and Finland, would also help in developing alternative services. However, institutional care can prove more cost-effective than home care in some cases, in particular for users in remote areas and those requiring intense care and supervision.

To support rebalancing LTC away from institutional care towards home and community-based care, policies in OECD countries also provide financial incentives for care recipients or carers. Yet increasing reliance on active family carers requires measures facilitating the combination of work and caring duties, for instance through flexible work schemes, and ensuring an appropriate level of compensation. In Slovenia, caregivers living in the same household as the insured care recipient are entitled to a compensation of only 7 (exceptionally 14) days a year, which is low and would need to be expanded.

Municipalities are meant to cover at least 50% of the price of the home care services, but small local authorities are encountering growing difficulties to do so. All but one municipality grants concessions for carrying out home care to a single provider, most often a public institution (Prevolnik Rupel et al., 2010). Alternatively, giving patients greater autonomy to organise their own care with a system of vouchers, as adopted in the Nordic countries, could enhance competition among home care providers and lower the price of services and municipalities' expenditure. At the same time, rewarding municipalities financially for reduced institutionalisation rates would prevent incentives to redirect patients towards centrally funded and more expensive institutional care.

### Box 2.3. **Policy recommendations to restructure welfare spending**

**Mitigating the dispersion of incomes**

- Continue to reduce high-income earners' eligibility for family benefits and strengthen means testing of education-related benefits.
- Ensure pension adequacy for the most vulnerable by raising the minimum insurance period of fifteen years.

**Rationalising cash transfers**

- Continue to gradually cut the combined generosity of unemployment benefits, social assistance and other transfers for the unemployed and inactive persons.

Box 2.3. **Policy recommendations to restructure welfare spending** *(cont.)*

- Enhance support for unemployed and streamline administrative costs by merging the Employment Service of Slovenia and the Centres for Social Work.

**Restructuring publicly provided services on health and education**

- Reduce costs by increasing pupil-teacher ratios in pre-primary and lower secondary education and class sizes in primary and lower secondary education.
- Introduce universal tuition fees along with means-tested grants and loans with income-contingent repayments to boost spending efficiency.
- Further rationalise the public health benefit basket, shifting from inpatient to ambulatory care and boosting the supply of general practitioners.

**Continuing the reform of the pension system**

- Further extend the pension eligibility age and contributory periods and index their further increases to gains in life expectancy. Phase out the gap between statutory and minimum retirement ages and effectively close other pathways into early retirement, including for special pension regimes.
- Consider further reducing the replacement rate by extending the pension rating base and lowering the effective accrual rates. Increase the weight of inflation in the pension indexation rule.

**Improving the financing of health care**

- Broaden the tax base of compulsory health insurance to working students and align the health insurance contribution of pensioners with the standard contribution of employees.
- Permit some increase in premiums with age of complementary health insurance.

**Enhancing long-term care**

- Implement reform plans of the financing of long-term care by setting up a specific funding system levied on the working-age population and pensioners.
- Develop home care by creating level playing field with institutional care in the accessibility to health services and giving patients more freedom to organise their own care with a system of vouchers.

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# Glossary

| | |
|---|---|
| **AETRs** | Average effective tax rates |
| **ALMPs** | Active labour market programmes |
| **AW** | Average worker |
| **BAMC** | Bank Asset Management Company (DUTB – *Druzbo za upravljanje terjatev bank*) |
| **CEEC** | Central and Eastern European Countries |
| **DEA** | Data envelopment analysis |
| **ECB** | European Central Bank |
| **EMU** | European Monetary Union |
| **ERC** | European Resolution Capital |
| **EU** | European Union |
| **EUR** | Euro |
| **FDI** | Foreign direct investment |
| **GDP** | Gross domestic product |
| **GPs** | General practitioners |
| **HIIS** | Health Insurance Institute of Slovenia |
| **IMAD** | Institute of Macroeconomic Analysis and Development |
| **IMF** | International Monetary Fund |
| **INSOL** | International Association of Restructuring, Insolvency and Bankruptcy Professionals |
| **LTC** | Long-term care |
| **NKBM** | Nova Kreditna Banka Maribor |
| **NLB** | Nova Ljubljanska Banka |
| **NPLs** | Non-performing loans |
| **PISA** | Programme for international student assessment |
| **PPP** | Purchasing power parities |
| **R&D** | Research and Development |
| **RWA** | Risk weighted assets |
| **SMA** | Securities Market Agency |
| **SMEs** | Small and medium-sized enterprises |
| **SOBs** | State-owned banks |
| **SOEs** | State-owned enterprises |
| **US** | United States |
| **USD** | United States dollar |
| **VAT** | Value-added tax |

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