



“Better Policies” Series

SLOVENIA

REFORMS FOR A STRONG
AND SUSTAINABLE RECOVERY

MAY 2014



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Foreword

During the last five years, Slovenia has endured a double-dip recession that has seen unemployment increase to unprecedented levels, especially among the youth. The situation has improved recently, thanks to major policy initiatives to strengthen the banking system, enhance bankruptcy legislation, reform labour market policies, and support low-income households through the tax-and-transfer system. In particular, last year's reform to employment protection legislation represents a milestone in the goal to tackle labour market duality, where a large proportion of workers, including many youth, are trapped in low-security, low-productivity jobs. Together with active labour policies, this reform should help address the country's unemployment problem and improve employment opportunities for those in greatest need.

Comprehensive structural reforms and improvements in competitiveness since 2010, the year Slovenia joined the OECD, are helping to consolidate the nascent economic recovery. But Slovenia also needs to lay the ground for faster convergence in per capita income and productivity levels with the leading countries. To achieve this objective, various structural reforms are in order. First, Slovenia needs to drop from the high-end of OECD rankings in barriers to product market competition, especially in the network industries and professional services. It also needs to attract more foreign equity investment, which will facilitate deleveraging in the corporate sector. Competition policy can be further strengthened and the corporate governance of its many state-owned enterprises needs to be enhanced, including through the appointment of professional and independent board members. Further reducing state ownership in the economy would also be beneficial.

Second, Slovenia would benefit from a thorough review of its education, training and innovation policies. While in general scoring relatively well in these policies, there is room for improvement. The education and training systems need to better correct regional disparities, as some areas end up with a high share of low-skill jobs. On innovation, Slovenia achieves good results in its public research sector, but it would benefit from greater autonomy and stronger links to the private sector to help turn some of the public R&D into viable commercial initiatives.

Third, Slovenia needs to reform its tax system in a revenue-neutral manner and correct rapid increases in ageing-sensitive expenditure, particularly pensions and healthcare. Reducing marginal tax rates on labour income while raising indirect taxes would boost employment creation while ensuring that it continues to address growing fiscal imbalances. The government also needs to push for a new reform of the pension system to enhance its long-term sustainability, building on the 2012 reform by raising further retirement ages and minimum contribution periods for a full pension. Such a reform should also contribute to increasing labour market participation among older workers, which is among the lowest in the OECD.

As Slovenia reforms, it should continue to protect some of its great achievements, such as having one of the lowest levels of income inequality and relative poverty in the OECD. In pursuing these goals, Slovenia could deliver sustained improvements in economic performance and increasingly inclusive growth in the years to come.



Angel Gurría
Secretary-General OECD

1. Introduction

Slovenia has suffered from a deep and prolonged recession but is now returning to growth. To support the recovery and improve the country's long-term economic outlook, reforms in three main areas are advisable. The most urgent priority is to strengthen further the banking system and continue the process of corporate deleveraging and privatisation, accompanied with improved corporate governance. Second, the sustainability of public finances needs to be reinforced, including by reforming further the pension and health care systems. Third, Slovenia would benefit from greater inflow of foreign direct investment and more efficient innovation policies that would improve the prospects for growth and productivity. All these reforms need to be implemented in ways that do not undermine the prospects of the most vulnerable.

Recent measures are supporting the recovery, but more is needed

Slovenia was hit hard by a boom-bust cycle, exacerbated by domestic reform backlogs and the euro area sovereign debt crisis. Nevertheless, amid improving sentiment, stronger investment and exports, and reviving consumption, growth is returning to Slovenia. Slovenia's growth prospects have improved substantially in recent years thanks to substantial gains in competitiveness and some major policy initiatives, including a landmark labour market reform in April 2013, an initial restructuring of the troubled banking sector and the newly-adopted bankruptcy legislation, which will facilitate restructuring of enterprises.

Despite this improving scenario, some structural weaknesses persist. The most immediate priorities for the government include restructuring of over-indebted companies, implementing the privatisation plan and improving the corporate governance of state-owned enterprises (**Chapters 4 and 8**). Consolidation in the banking sector is warranted and bank supervision needs to be strengthened. The government is also committed to continue to improve public finances, bringing the deficit below 3% of GDP by end-2015. While letting automatic stabilisers operate fully, the government needs to address the fast-growing items in its expenditure. In particular, reforms to pensions and health are pressing in order to ensure the long-term financial sustainability of these systems as demographic ageing intensifies. (**Chapter 6**)

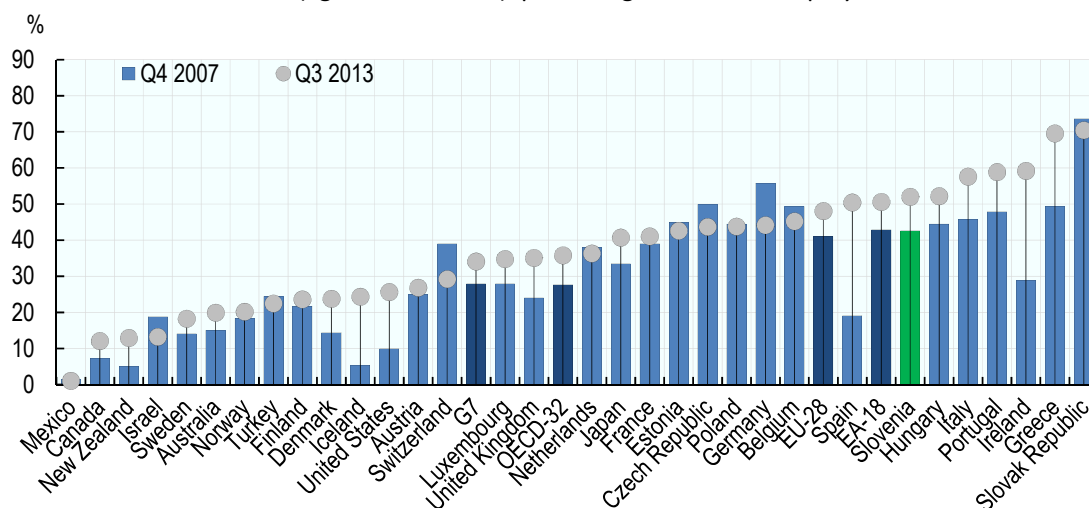
The tax system could be reformed in a revenue-neutral manner to better support inclusive, sustainable and green growth (**Chapter 7**). Marginal tax rates on labour income are amongst the highest in the OECD. They could be reduced, shifting revenues towards indirect taxes. Environmental tax policy, although already very effective in terms of its revenue-raising capacity, also needs to be reviewed (**Chapter 9**). For instance, diesel is taxed at a lower rate than petrol, which does not reflect the greater environmental externalities of diesel.

Unemployment is stabilising but is still high and hitting the youth hardest

The unemployment rate rose by around 6 percentage points since the start of the global financial crisis in late 2007 to reach close to 10% in Q1 2014 and is expected to stay at around this level until 2015. More than one in two unemployed persons had been out of work for one year or more (Figure 1), which represents an increase of close to 10 percentage points since the onset of the global financial crisis and is well above the OECD and Euro area averages. Long spells of unemployment can result in skills depreciation and a loss of motivation for finding work, turning into structural unemployment. Further development of active labour market programmes could help the long-term unemployed to find new jobs or access training that will improve their employability (**Chapter 2**).

Unemployment has risen most among young people, more than doubling since the start of the crisis to around 23% at the end of 2013, higher than the OECD average of 16%, but well below the rates of over 30% reached in Greece, Italy, Portugal, the Slovak Republic and Spain. There has also been a small rise in the share of the youth population that is not in employment or in education and training (NEET). High youth unemployment calls for policies to create employment opportunities for youth, ensure they acquire skills sought after by employers and reduce the number of early-school drop-outs. An effective implementation of the 2013 Employment Act will help reduce labour market duality, and future rises in the already high minimum wage should be moderated to improve the labour market inclusion of younger and low-skilled workers.

Figure 1. Long-term unemployment
Overall (aged 15 and over), percentage of total unemployment



Note: Countries are shown in ascending order of the overall incidence of long-term unemployment in Q3 2013. Data are not seasonally adjusted but smoothed using three-quarter moving averages. OECD-32 is the weighted average of 32 OECD countries excluding Chile and Korea.

Source: OECD calculations based on quarterly national Labour Force Surveys (Cut-off date: 5 March 2014).

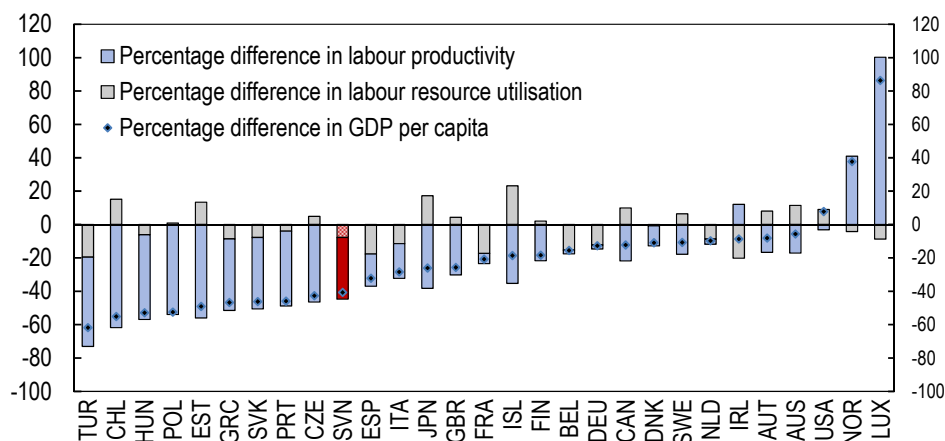
Structural reforms are needed to boost productivity and growth

After having narrowed steadily prior to the crisis, the gap in GDP per capita vis-à-vis the upper half of OECD countries has widened since 2008, primarily reflecting a labour productivity shortfall (Figure 2). Compared to Central and Eastern European Countries (CEEC), Slovenia's export market performance has stagnated since the crisis although it improved in 2013, while competitiveness, after a sharp deterioration between 2008-09, has subsequently improved on the back of falling unit labour costs (Figure 3).

Medium and long-term growth prospects are held back by population ageing, which will reduce labour force participation, and slow productivity growth. To boost productivity, three main actions are needed. First, the education system requires a regional rebalancing of resources, in order to address disparities in the quality of education across regions (**Chapter 3**). Second, more efficient innovation policies should be put in place that link up publicly-funded academic research with private sector initiatives, together with efforts to promote entrepreneurship (**Chapter 5**). Third, a range of product market reforms are needed, notably reducing state involvement in the economy, increasing foreign direct investment inflows to

facilitate technology transfer and removing overly strict regulations of professional services (**Chapter 4**). In addition to supporting raising productivity growth, such reforms could have positive long-term effects on the labour market.

Figure 2. Difference in GDP per capita with the upper half of OECD countries

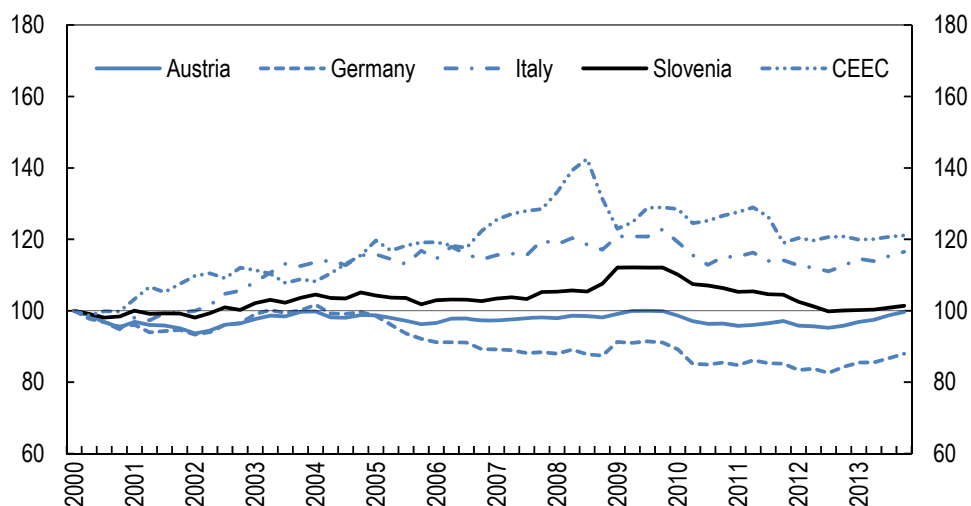


Note: compared to the simple average of the OECD countries with the highest GDP per capita in 2012, based on 2012 purchasing power parities (PPPs). The sum of the percentage difference in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita difference since the decomposition is multiplicative. Labour resource utilisation is measured as the total number of hours worked per capita. Labour productivity is measured as GDP per hour worked.

Source: OECD Economic Outlook 95 database

Figure 3. Real effective exchange rates

Index, 2000=100



Note: Real effective exchange rates based on unit labour costs for the total economy. A rise in the index represents a deterioration in competitiveness.

Source: OECD Economic Outlook 95 database; and OECD Main indicators database.

Low income inequality has been largely preserved during the crisis thanks to generous social transfers

Income inequality has remained remarkably stable and low in Slovenia, including during the years of the crisis. Indeed, Slovenia ranks among the three most equal OECD countries, together with Iceland and Norway. Relative income poverty is also considerably below OECD average: only about 9% of Slovenians live in households with less than half the median income. Slovenia's equity and poverty indicators result largely from the relatively high effectiveness of the tax and transfer system.

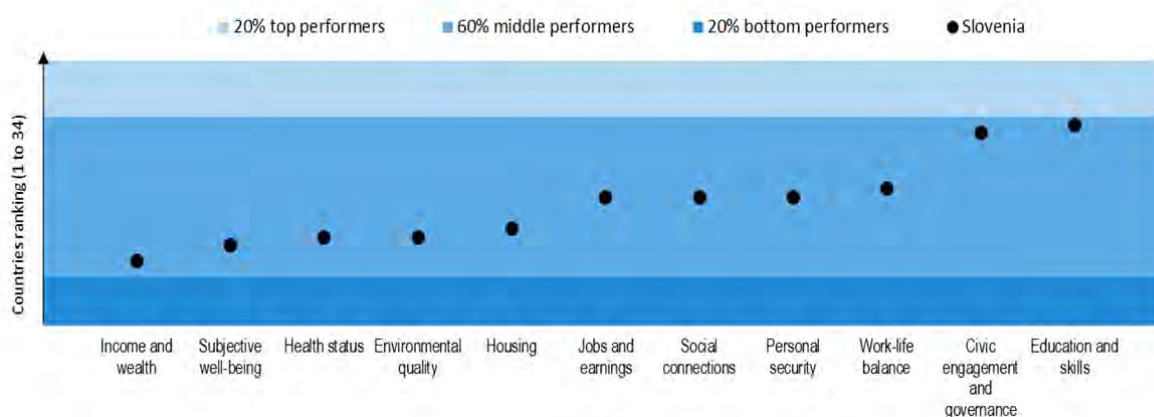
In the first four years of the crisis, market income inequality rose as unemployment increased but inequality in disposable income (after taxes and transfers) barely changed. As a matter of fact, social transfers increased and income taxes decreased more in Slovenia than in other OECD countries. There has been a slight increase in income poverty since 2007, especially among households with children, whereas the elderly (65+) have experienced a decline in relative poverty rates. However, poverty among the elderly remains 1.7 times higher than for the total population, and twice as high than among children.

Slovenia displays a surprisingly strong social gradient in health conditions and life satisfaction

Slovenia performs relatively well only in two of the dimensions that matter the most to people's lives (Figure 4), education and skills, and civic engagement and governance. In most of the other well-being dimensions, Slovenia records scores comparable to the rest of the OECD area, while it ranks below the OECD-average in terms of income and wealth, subjective well-being, health status (particularly self-reported health conditions), environmental quality (with a significant level of air pollution) and housing conditions (notably small dwellings size).

Despite low income inequality, Slovenia also displays a strong social gradient (i.e. better outcomes among people with higher socio-economic status) in various well-being dimensions, notably in health status and life satisfaction.

Figure 4. Slovenia's performance in well-being, 2013



Source: OECD How's Life? 2013 Measuring Well-Being.

2. Tackling unemployment and improving the functioning of the labour market

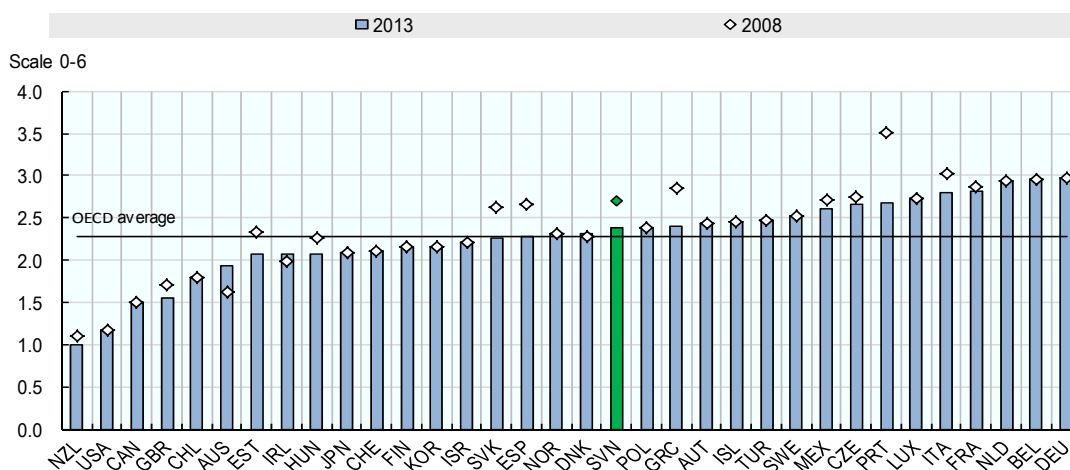
With Slovenia's economy slowly emerging from recession and unemployment set to remain high, action must be taken to correct a number of structural barriers to job creation and to help the unemployed find jobs. This includes more effective targeting of active labour market programmes on the youth and long-term unemployed, greater moderation in minimum wage growth and further reforms to tackle labour market dualism.

The 2013 Employment Act will help reduce labour market duality

In Slovenia, 18% of employees hold a temporary job compared to an OECD average of 14%, and this share is on the rise. Indeed, the share of permanent contracts among new hires is extremely low: only 1 in 5 new recruits in 2012. Temporary contracts are particularly prevalent among youth. In 2011-2012 about 3 in 4 employees aged 24 years or less were on a temporary contract, three times more than the OECD average. Precarious jobs are sticky: less than 50% of workers who were on a temporary contract in 2008 managed to move into a full-time permanent job within three years.

The main cause of this high level of dualism in the Slovenian labour market is the difference in dismissal terms between temporary and permanent contracts. Before the Employment Relations Act which entered into force in April 2013, Slovenia had one of the most restrictive employment protection legislations (EPL) for permanent contracts in the OECD, while employers incurred no direct cost when terminating fixed-term contracts at the end date. The 2013 reform was a bold step in fostering convergence of termination costs across contracts, thereby gradually reducing dualism. As measured by the OECD EPL indicators, this policy step was one of the most comprehensive reforms of dismissal legislation taken by OECD countries during the crisis (Figure 5). As a result, Slovenian legislation on this dimension is now just slightly more rigid than the average OECD country.

Figure 5. Protection of permanent workers against individual and collective dismissals



Note: the indicator varies between 0 and 6 from the least to the most restrictive. 2008 data reflects legislation in force on 1st January 2008. 2013 data reflects legislation in force on 1st May 2013.

Source: OECD Employment Protection Database.

As a result of the reform, in the case of fair termination, employers' costs are the same across contract types. Yet, at the end of a fixed-term contract, workers still cannot file a complaint for unfair dismissal in courts, while permanent workers can. Hence, to the extent that the main avenue for redress in the case of unfair dismissal remains the reinstatement of the worker with backpay, the expected cost of termination remains higher for permanent contracts.

Overall, the reforms have not entirely eliminated the relative attractiveness of temporary versus permanent contracts, but they have reduced it substantially. As a result, there are clear signs of declining labour market dualism. In period from April to December 2013, the number of new permanent contract was 36.4% higher than in the same period 2012, while the number of new fixed term contract declined by 9.2%.

The high minimum wage can be a barrier to employment

Out of the 25 OECD countries with a legal minimum wage, Slovenia is one of the five countries with the highest minimum wage relative to median wages, after Turkey, Chile, France and New Zealand. Relative to full-time median earnings, the minimum wage increased by 8 percentage points from 51% in 2005 to 59% in 2012. This is mainly due to the 20% increase in the minimum wage between 2009 and 2010. High minimum wages can be a barrier to employment of youth and low-skilled workers. They can also increase wage pressures across the economy once the recovery sets in and therefore damage Slovenia's competitive position. The Slovenian government and social partners should therefore ensure that future revisions in the minimum wage are tied to inflation for a prolonged period, reducing its level over time relative to the median wage.

Enhancing active labour market policies

Since the late 1990s, Slovenia has emphasised activation measures. During the 2000s, the eligibility conditions for unemployment insurance benefits was restricted, although benefit replacement rates remained much higher than in other CEEC countries. Early in the crisis, job-sharing labour market programmes were introduced and expenditure on active labour market programmes was increased, but this did not prevent unemployment from rising steadily. Expenditure on passive labour market programmes increased sharply but active spending has not always increased in proportion: in 2011, Slovenia spent 1.23% of GDP, close to the OECD average, on labour market programmes overall, of which only 0.36% was on active programmes. 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.

Slovenia's range of active labour market programmes seems balanced, with potential for labour market outcomes to recover in a context of adequate work incentives and improved cost competitiveness. However, to tackle the large recent fall in youth employment rates, various measures are needed: realistic vocational guidance, measures to reduce lengthy tertiary education in fields with poor labour market prospects and further reducing the rigidity of permanent employment contracts. Active measures should prevent the use of unemployment benefits for early retirement, and ensure that the long-term unemployed remain attached to the labour market. Benefit replacement rates should also be reduced to increase incentives for job-seeking.

Key OECD recommendations

- **Limit the possibility for courts to order reinstatement after unfair dismissal** to cases of discrimination and dismissal on a prohibited ground.
- **Rigorously evaluate the newly introduced exemption from social security contributions for hiring on permanent contracts** in order to identify and correct possible costs since they are not targeted.
- **Limit minimum wage rises to inflation** and adopt a new social agreement to maintain wage moderation as the economy recovers.
- **Develop public labour market programmes to provide targeted assistance to the long-term unemployed** to help them find jobs or access training that will improve their employability.
- **Encourage youth to acquire qualifications sought after by employers**, from both traditional education and vocational training.
- **Shelter resources currently devoted to training and job search services** from ongoing fiscal consolidation efforts, to support employment and ensure that the long-term unemployed remain attached to the labour market.

3. Enhancing skills to support productivity growth

Better investment in skills would help Slovenia to realise the potential of technological progress and give a new impetus to productivity growth. Without such investment, unemployment could become entrenched. While Slovenia has made progress in raising the performance of its education system, both the equity and quality of compulsory education can be improved further. The higher education system should equip a larger share of young people with a wider range of relevant skills.

Ensure that all youth achieve a good level of foundation skills

Initial education should help all youth develop strong foundation skills to enhance their ability to learn more and to apply their learning across a range of fields. Average achievement scores for 15-year-olds in PISA 2012 were relatively high (above OECD average) in mathematics and science but below the OECD average in reading. Performance in reading has decreased over time. The impact of socio-economic background on performance is similar to the average of other OECD countries, but the share of top performers from an immigrant background is low.

A better allocation of spending in compulsory education would help raise education outcomes. The average class size is relatively low in Slovenia, which reflects some misallocation of spending by geographical areas and a lack of systemic response to demographic changes. Revising the geographical distribution of spending and classes would free resources that could be used to help improve the performance of students from low socio-economic or immigrant backgrounds. More flexibility in the organisation of pedagogical work and the implementation of curricula would make it easier to account for specific needs of some students. Identifying weaknesses of the evaluation and assessment process of education is also of prime interest.

Develop the skills needed in a changing and increasingly globalised world

The specialisation of Slovenian industry in low and medium-technology goods is partly a consequence of Slovenia's pattern of human capital investment. Both at upper- and post-secondary levels, education has a strong vocational focus. However, student interest in short upper-secondary vocational education and training (VET) has diminished, leading to some shortages in low-skilled manual jobs. There are also signs of mismatches between the output of the higher education system and the needs of the labour market, with gaps in engineering and science.

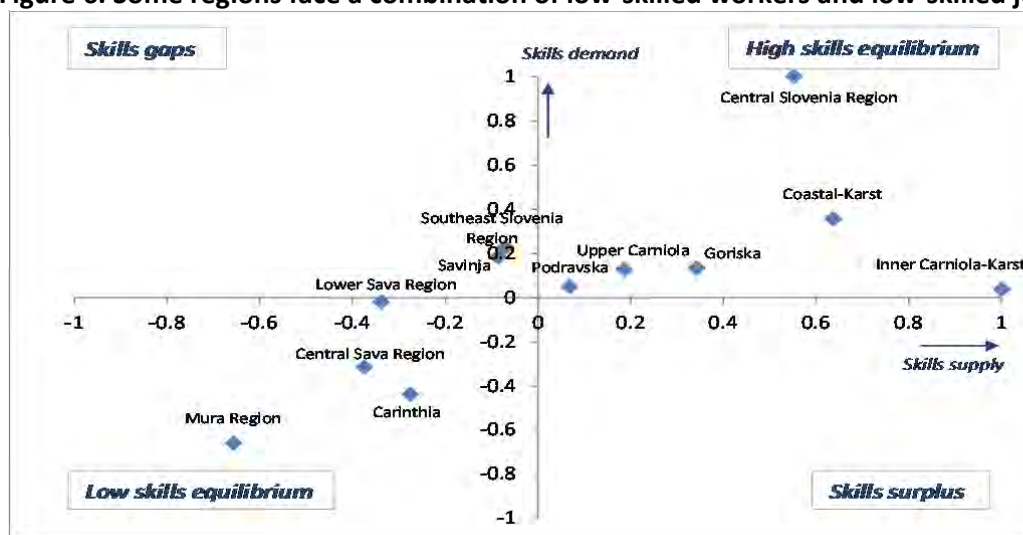
Participation in adult education programmes is relatively high but, as in many countries, tied to best-educated and prime-age workers. There are also regional mismatches, with some regions facing a shortage of high-skilled workers. Some regions have successfully moved to a high-skills equilibrium while others seem trapped with low-skilled jobs for low-skilled workers (Figure 6). An integrated approach to skills supply and demand which pays attention to how skills are used by employers would improve both skills and productivity.

A major challenge is to reform the VET system in a way that equips people with the skills needed by the fast-changing labour market. VET systems should help students to develop both foundation skills and acquire more technical capabilities. There should also be pathways between these programmes and from these programmes to post-secondary and general higher education programmes. The government has started to introduce these pathways. In international comparison, however, the involvement of stakeholders in the Slovenian VET system remains limited although there has been some progress in

involving social partners in curriculum design and in increasing the share of practical training in the work place.

Tertiary education is an important factor in boosting innovation and growth and Slovenia should consider increasing funding for tertiary education. University attainment rates are below the OECD average, for both young and older cohorts. The university funding system also tends to favour historically well-established universities, unrelated to the quality of courses, while the implementation of a quality assurance system is in an early phase. Addressing these inefficiencies would boost available resources on a per-student basis, which is well below the OECD average, but may not be enough to fill funding gaps in the face of tight budget constraints. Introducing universal tuition fees associated with a system of means-tested grants and loans with income-contingent repayment has the potential to bring funding of tertiary education more in line with the needs of a modern and innovative economy. This is likely also to shorten completion times for tertiary education, which are currently high by international standards.

Figure 6. Some regions face a combination of low-skilled workers and low-skilled jobs (2011)



Note: The figure shows, per region, the percentage of population with tertiary education (on the supply side) and a combination of the percentage of employment in medium-high skilled occupations and labour productivity (on the demand side). The indicators are presented as differences from the national average.

Source: OECD (2014), *Job Creation and Local Economic Development*, forthcoming, 2014.

Key OECD recommendations

- **Improve spending efficiency in basic compulsory education** by reviewing the geographical distribution of spending. Identify and rectify weaknesses in the evaluation of education.
- **Facilitate further transitions from VET to higher education**, including to university education. Better inform students who are interested in VET about career opportunities. Increase employer involvement in VET programmes.
- **Improve the funding and efficiency of the higher education system**. Give more weight to performance in the allocation of financing. Introduce universal tuition fees associated with a system of means-tested grants and loans with income-contingent repayment.
- **Evaluate the impact of adult education programmes on labour market outcomes and assess how skills are used by employers**. Improve the accessibility of adult education for individuals with low educational attainment levels.

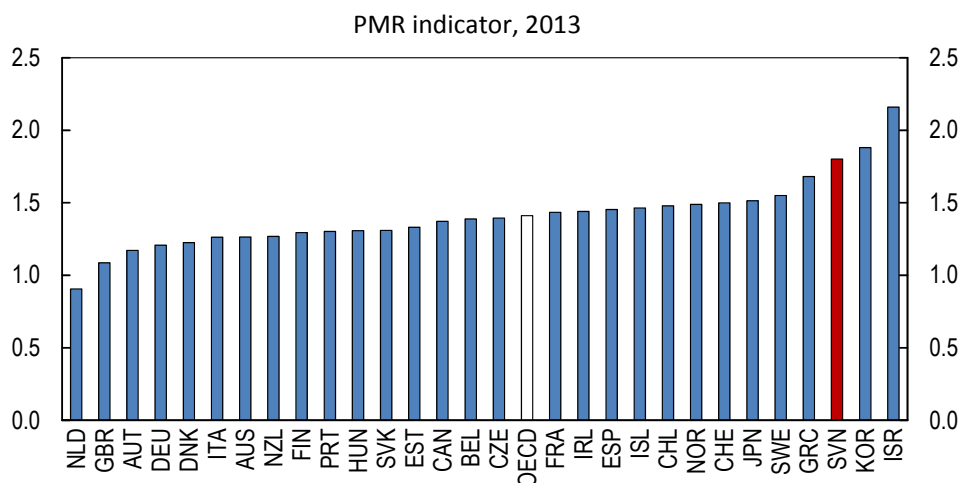
4. Lowering barriers to product market competition and strengthening corporate governance of state-owned enterprises

There is much scope for competition reform in Slovenia. Competition is held back by state involvement in the economy, especially in network sectors - transport, energy and communications - but also due to complexity of regulatory procedures. Competition in professional services could also be strengthened by easing entry barriers, thereby affecting the quality, variety and price of services. Enhancing competition in these sectors would provide a major boost to productivity growth. There is also a need to enhance the corporate governance of state-owned enterprises.

Addressing regulatory barriers to competition

Product market regulation is essential for well-functioning market economies. Yet, some regulations can create unnecessary barriers to market entry, and limit choice and competition. Slovenia's overall regulatory framework is among the most restrictive in the OECD, as indicated by the OECD product market regulation (PMR) indicator (Figure 7), largely because of its high state involvement in the economy, complexity of regulatory procedures and barriers to trade and investment.

Figure 7. Product market regulation is overly strict



Footnote: The numerical PMR indicators represent the stringency of regulatory policy in specific areas on a scale of 0 to 6 with a higher number indicating a policy stance that is deemed less conducive to competition. In each case, it characterises the stance of regulation as it stood in early 2013.

Source: OECD PMR indicators database.

Public ownership and control of enterprises is widespread in Slovenia. State-owned enterprises (SOEs) are most common in network industries, which often have a natural monopoly, but are also major players in banking and insurance, and in manufacturing. Poorly-designed regulation and weak competition result in higher prices for energy, telecommunications and transport with significant knock-on effects on the competitiveness of firms producing final goods and services. Reducing public ownership, ensuring efficient regulation for privatised monopolies and simplifying administrative procedures could bring in more FDI as well as boost competitiveness through direct technology transfers and spill-overs. In June

2013, Parliament approved a list of 15 SOEs to be privatised, including one state-owned bank and a major telecom provider. As of April 2014, two SOEs had been sold.

Slovenia should also further ease the regulation of professional services. Accounting, legal, engineering and architecture services face overly strict entry barriers as incumbents have exclusive rights to perform certain tasks, education requirements are excessively high and chamber memberships are compulsory. Considering that services sectors are generally less exposed to foreign competition than manufacturing, regulation should facilitate competition in these sectors.

The enforcement of competition policy should be strengthened

Slovenia implemented several amendments to its competition law in 2012 and 2013. Most importantly, in January 2013 a new, independent public agency, the Slovenian Competition Protection Agency (CPA), took over the responsibility for enforcing competition law. The CPA, being more independent than its predecessor, should be able to continue and enhance both competition enforcement and competition advocacy in Slovenia, in line with EU law. However, its approach with respect to abuse of a dominant position may result in an overabundance of cases in which there is no competition problem from the perspective of effects-based economic analysis. The resources of the CPA are also inadequate, which limits its potential to recruit and retain experienced and well trained staff, jeopardising its ability to fulfil its mandate.

Bolstering the corporate governance of SOEs

Slovenia's significant direct and indirect control over a large number of sizeable companies in the domestic market has allowed past governments to exercise a substantial and sometimes opaque role. The OECD accession review in 2009 recommended that Slovenia centralise the management of its ownership in the form of an ownership agency, and that the agency should "quickly develop policy instruments that will enable it to successfully execute its function." While there has been some progress since, the government is yet to agree on an asset management strategy (to be agreed by parliament).

An important breakthrough was achieved with new legislation enacted in April 2014, which allows a new, centralised entity, the Slovenian Sovereign Holding (SSH), to become operational even if Parliament cannot agree on the asset management strategy proposed by the government. The Act also includes specific authorisation for SSH to decide on the disposal and voting of shares held by existing funds under state ownership, strengthening its capacity to manage and dispose of remaining state-owned assets.

Effective implementation of the new SSH law is critical. It should be a priority to develop an asset management strategy and implement a range of measures aimed at ensuring effective ownership oversight. Among the important next steps will be the appointment of professional SSH board members capable of acting with independent judgment in their companies' interests and the development of more detailed plans and policies for the SSH's future operations. It is also important to ensure high quality disclosure and transparency requirements for the remaining SOEs.

Key OECD recommendations

- **Reduce the scope of public ownership in the economy** including in network industries (energy, transportation and communication). Reduce unnecessary regulatory burdens in these sectors.
- **Reduce entry barriers in professional services** - accounting, legal, engineering and architecture.
- **Increase the resources of the Competition Protection Agency, and secure its full independence** to enable it to perform its role efficiently and support the implementation of pro-competition reforms.
- **Strengthen the corporate governance of SOEs**, including through the appointment of professional board members capable of independent judgement and effective implementation of the new SSH law.

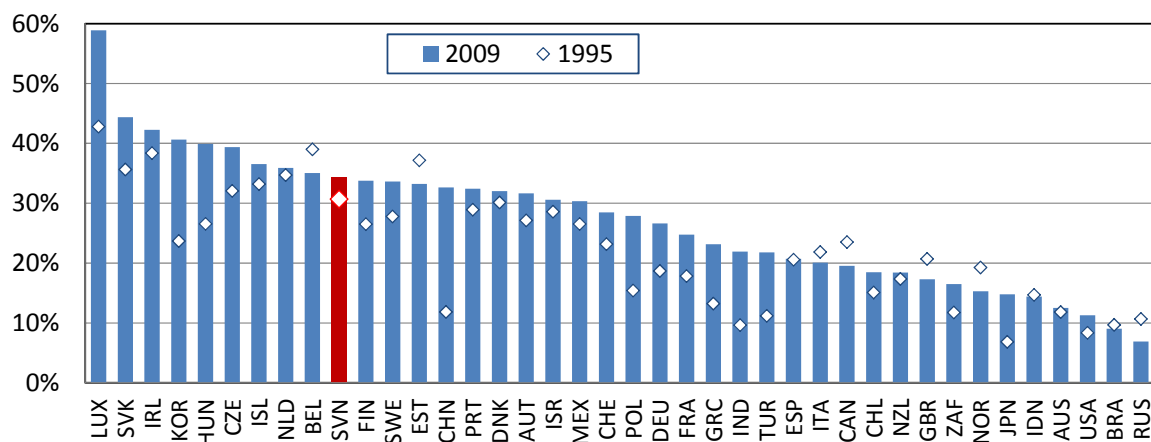
5. Boosting innovation and moving up the value chain

As a small open economy, Slovenia must integrate further into global markets to sustain productivity growth. To maximise the benefits from Global Value Chains (GVCs), Slovenia must further strengthen the innovation system, foster productivity gains in all sectors, attract foreign direct investment (FDI) and diversify into economic activities of higher value added.

Integration in Global Value Chains

Slovenia has been rapidly integrating into world markets, as shown by the increasing and relatively high share of the import content of Slovenia's exports, which reached just under 35% in 2009 (Figure 8). A productive services sector is key to upgrading the activities of Slovenian firms in GVCs. In 2009, 43% of the value added of Slovenian exports consisted of services, which is slightly below the OECD average (48%).

Figure 8. Foreign content of gross exports, 2009, %



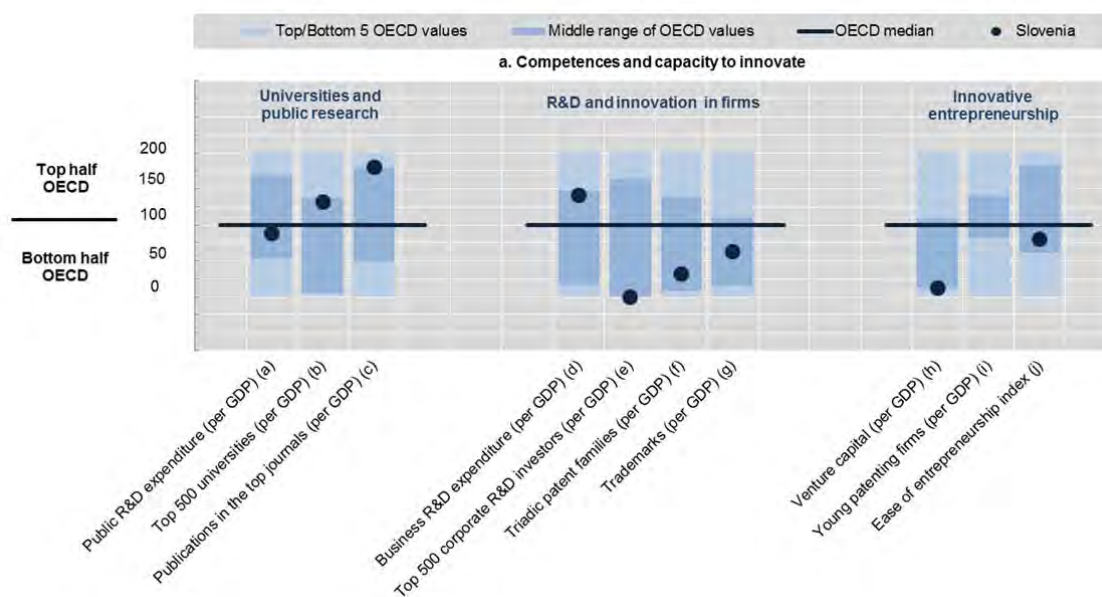
Source: OECD (2013), "OECD/WTO Trade in Value Added (TiVA) Indicators – Slovenia".

Boosting innovation and entrepreneurship

Investment in knowledge-based capital (KBC) - and innovation more generally - has an important role to play in increasing productivity and helping countries move up the value chain. Slovenia leads central and eastern Europe in a range of innovation-related indicators. Expenditure on research & development (R&D) even grew during the 2008-09 economic crisis and afterwards, but pressure on public finances meant that government budgets for R&D were reduced in 2012 and remained unchanged in 2013. Still, in 2012, expenditure on R&D as a share of GDP stood at 2.6% (Figure 9) – ahead of the OECD average of 2.4% – just over three-quarters of which was performed by businesses.

Slovenia's potential for benefitting from technology spillovers through inward FDI is not fully realised due to small inflows of FDI relative to other central and eastern European countries. The Slovenian innovation system also appears unable to maximise the benefits of existing technologies for new innovative purposes given the low level of patents and trademarks per capita (Figure 9) and the small share of high-technology exports. Results from innovation surveys also show little change in innovation activity in the manufacturing sector and only a gradual increase in services. There are also barriers to entrepreneurship, such as insufficient access to finance.

Figure 9. Science and innovation in Slovenia
Comparative performance of national science and innovation systems, 2013



Note: Normalised index of performance relative to the median values in the OECD area (Index median=100). Slovenian data on young patenting firms (i) is not available.

Source: OECD Science, Technology and Industry Outlook 2014 (forthcoming).

To boost innovation, the government also needs to continue supporting the public research sector, universities and public research organisations (PROs). Public research has delivered some impressive results in the past in terms of scientific output (Figure 9). But the internal organisation of universities and PROs could be modernised, enhancing their strategic management as autonomous organisations, fostering accountability by tying resources to performance, and strengthening links with the private sector. Low levels of entrepreneurship and the absence of incentives to commercialise research also act as barriers to technology transfer.

Key OECD recommendations

- **Boost productivity by implementing policies to spur innovation** (e.g. process and organisational innovation, including non-technological innovation), enhance knowledge-intensive skills (in engineering, design, marketing, information technology and R&D) and increase associated investments (including advanced machinery, software and databases, branding, firm-specific human capital and organisational capital).
- **Encourage entrepreneurship, start-ups, and technology transfer.** Improve the framework conditions for innovation and entrepreneurship, including better access to finance, and attract FDI.
- **Improve the governance of public research by facilitating reform in universities and PROs** to enhance their autonomy, strengthen evaluation of innovation support programmes and strengthen links with private sector innovation and entrepreneurship.

6. Return to sustainable public finances

Despite ambitious consolidation in recent years, the public debt remains high after costly bank recapitalisations. To put public debt on a declining path, Slovenia will need to maintain sustained primary surpluses for some time, but automatic stabilisers should be allowed to operate fully to support the recovery. In addition, further reforms are needed to offset rising pressures on public spending in health-care, pensions and long-term care. However, they must be done in ways that protect the most vulnerable.

The public debt has been rising rapidly since the crisis

Public debt is expected to rise beyond 80% of GDP in 2015, boosted by large deficits since the onset of the crisis and bank recapitalisations (Figure 10, panel A). Following the government's recapitalisation of the three major state owned banks in 2013, shareholders are required to meet the capital needs of the remaining five banks, but there is a risk that a large part of their recapitalisation (up to 2% of GDP) will fall on the government. Nevertheless, the successful start of restructuring of banks has calmed financial markets and the sovereign bond yield has significantly abated, with improvements in banks' and sovereign ratings.

The government aims to bring the deficit to below 3% of GDP by end-2015, in line with its commitments under the Excessive Deficit Procedure of the EU. However, a new real estate tax planned for 2014 has now been contested by the Constitutional Court, posing a challenge for collecting the planned revenues of 0.6% of GDP. The government has reacted by raising excise duties and further containing spending. It should firmly stick to its underlying consolidation path, as fiscal slippage could again worsen the risk perception of Slovenia on financial markets.

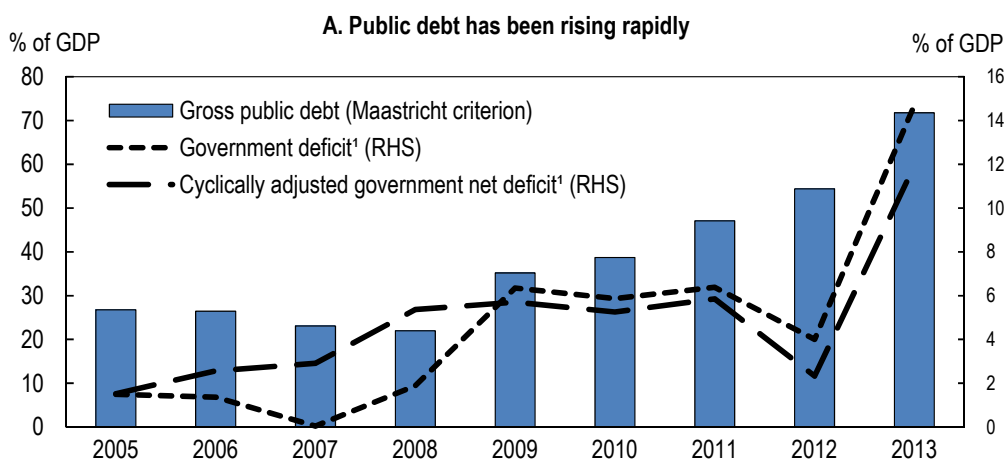
Slovenia will need to maintain sustained primary surpluses for some time

To stabilise debt at 60% by 2030 Slovenia needs to consolidate on average 0.9 percentage points of GDP per year beyond 2015 (the difference between the projected underlying primary balance in 2015 and the *average* underlying primary balance to 2030). This comparatively small required *further* consolidation is due to a low absolute level of public debt in the European context (Figure 10, panel B). However, the task is made more challenging by the need to accommodate increased expenditure pressures from health and pensions. For Slovenia, under no further reform, OECD projects additional increases in public spending on healthcare, long-term care and pensions of 3.1 percentage points of GDP between now and 2030. This will therefore need to be offset to contain government indebtedness.

A new pension reform will be needed soon

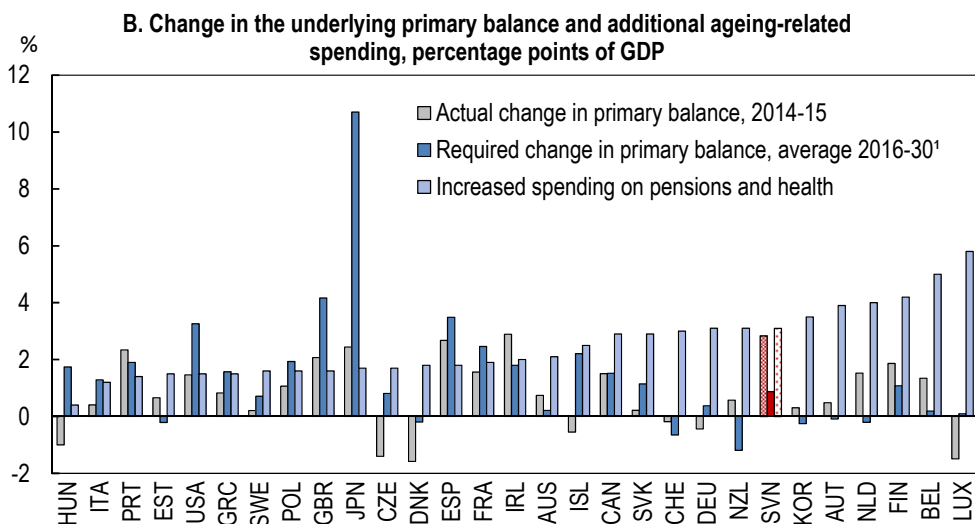
Public spending for old-age pension is high in international comparison, and rapid population ageing could threaten the sustainability of the pension system. In 2009, Slovenia spent 11% of GDP on old-age and survivor pensions (all public) against 9% for the OECD on average. According to the 2012 EU Ageing Report, such public spending is projected to dramatically increase by 7.5 percentage points of GDP between 2010 and 2060 compared with 1.7 percentage points for the EU27 average. The financing challenge stems partly from the low retirement age and the concomitant low labour force participation of workers aged 55-64, which at just above 30%, is the second lowest in the OECD.

Figure 10. Rising public debt and consolidation requirements



Note: Deficit in positive territory means negative government balance.

Source: OECD Economic outlook 95 database.



Note: (1) The average measure of consolidation is the difference between the underlying primary balance in 2015 and the average underlying primary balance between 2016 and 2030, except for those countries for which the debt target is only achieved after 2030, in which case the average is calculated up until the year that debt target is achieved.

Source: OECD STEP 95 long-term database.

The December 2012 pension reform will raise the statutory retirement age to 65 (for those with at least 15 years of contributions) and equalise it between men and women. But workers will be able to retire with a full pension at age 60 with at least 40 years of contributions. The reform also introduces a less generous indexation of pension benefits and reduces slightly the accrual rates. The reform will only stabilise pension expenditure up to 2020. To improve sustainability, further increases in the effective retirement age are required. This should be achieved by further raising minimum and statutory retirement ages and minimum contribution periods for a full pension, in line with gains in life expectancy.

At the same time, the reform should ensure effective protection against old-age poverty. Short contribution years raise adequacy issues and targeted old-age benefits, while not especially low, are insufficient to fight poverty: at about 17%, the old-age (65+) relative poverty rate, that is those earning less than one-half of median income, is much higher than for other age groups and is also significantly above the OECD average (12%). Targeted benefits might therefore need to be raised to curb old-age poverty.

Health care could be further rationalised

Total health spending accounted for 9% of GDP in Slovenia in 2011, just below the OECD average of 9.3%. A relatively large share of health expenditure, 14%, is for private insurance (vs. an OECD average of 6%), with three main providers offering complementary insurance to 3 out of 4 citizens. Premiums for private insurance do not vary with age and insurers cannot refuse coverage, which has improved access to private insurance and contributed to a relatively low level of out-of-pocket spending. This contributes to good access to health care. Slovenia has the lowest proportion of people reporting unmet needs for medical reasons in Europe (less than 1% among the people with low income). There are nonetheless gaps in access to services, for example an almost 30% difference in colorectal cancer screening between people with low and high educational levels.

Slovenia has been seeking to redress the balance between primary and secondary care, characterized by a low supply and high salaries for primary care doctors. A move towards a mixed capitation/fee-for-service remuneration system in primary care, linked to basic performance indicators, would preserve high salaries for best performing doctors and provide incentives to a better use of existing capacity.

Improving public sector efficiency at the local level

In contrast to the pattern observed in many OECD countries, the number of municipalities in Slovenia has grown over the last 20 years. Many municipalities are too small to provide public services efficiently or to implement potentially growth-enhancing investments. There are important incentives for fragmentation in access to finance, as the funding formulae used in municipal financing tend to be more generous for smaller and less dense municipalities. Additional financial incentives should be provided to jurisdictions that implement new types of co-operative relationships.

Key OECD recommendations

- **Maintain sustained primary surpluses for some time** to put public debt on a declining path. In addition, further reform is needed to offset expected expenditure pressures in health-care, pensions and long-term care.
- Pursue pension reform by **gradually raising the minimum and statutory retirement ages and contributory periods further**, indexing them to life expectancy.
- **Reform methods of paying general practitioners** to encourage desirable activities such as prevention and focus on performance indicators linked to quality.
- **Make progress with municipal mergers** and develop new forms of inter-municipal co-operation in order to put local finances on a more stable footing.

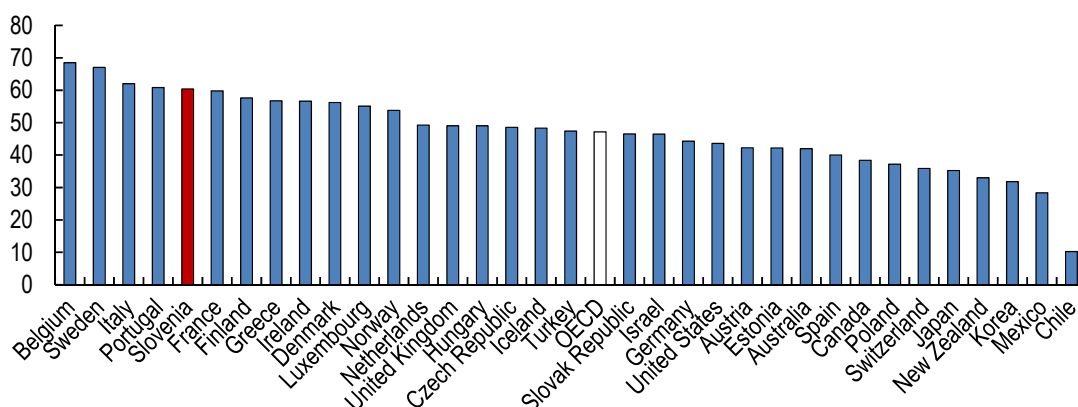
7. A tax system that supports inclusive and sustainable growth

Slovenia has the opportunity to reform its tax system in a revenue-neutral manner to better support inclusive and sustainable growth. The total tax take (37.4% of GDP in 2012) is already high. A key challenge is to reduce tax rates on labour income, which are high across the board. These reductions could be financed by curtailing various tax expenditures in an equity-friendly manner. Slovenia leads the OECD in total revenues from environmentally-related taxes but can contribute to better environmental outcomes by improving the design of these taxes.

Reducing tax rates on labour income

Reducing marginal tax rates on labour income should be Slovenia's top priority for tax reform. The marginal tax wedge – that is, the fraction of an extra euro of labour costs that is kept by the government through personal income taxes (PIT) and social security contributions (SSCs) – is high across the income distribution. At 167% of the average wage, the marginal tax wedge in Slovenia is 60%, one of the highest rates in the OECD (Figure 11). Reducing the tax wedge on labour would encourage hiring, labour force participation and investment in skills. At the top of the income distribution, with the introduction of a 50% PIT rate; the marginal tax wedge is 66%. The resulting negative impact on incentives is likely to outweigh any positive impact on revenues, such that any positive effects on the distribution of income are most likely diluted.

Figure 11. Marginal tax wedge (%), single workers¹ earning 167% of the average wage, 2013



¹ Without dependents.

Source: OECD Economic Outlook Volume 2013 (No. 94)

Relying less on tax expenditures and making them fairer

Slovenia should finance cuts in PIT and/or SSC rates by curbing tax expenditures. Since marginal tax rates at higher income levels need to be reduced, offsetting tax increases should be designed so that the overall tax reform does not make the distribution of income less equal. To this end, Slovenia should convert some PIT deductions (e.g. for SSCs and for dependent children) into flat-rate credits, remove exemptions and other tax preferences for certain forms of income (e.g. severance pay, pensions and capital gains on long-held assets), and consider shifting from flat-rate taxation of personal capital income to modestly progressive rates.

Slovenia should also increase indirect taxes to finance tax cuts for labour income. At 22%, the standard value-added tax (VAT) rate is already high. Nevertheless, Slovenia applies a reduced VAT rate (9.5%) to a wide range of goods and services. One approach would be to start by moving from the reduced VAT rate to the standard VAT rate those goods and services that are disproportionately consumed by higher-income households (e.g. books, cultural services, hotels and restaurant meals). As in other countries, targeted investments to improve compliance and guard against fraud are also important to sustain VAT revenues over time.

Increasing taxes on immovable property

The taxation of residential and other immovable property is a key element of a tax system that supports inclusive and sustainable growth. This form of taxation has been found to have relatively limited effects on economic growth, and it can be designed to take account of distributional and environmental concerns. Slovenia has ample room to increase recurrent taxes on immovable property. Its tax revenues from taxes on property in 2012 were a mere 0.6% of GDP, one third of the OECD average. The Real Estate Tax Law recently annulled by the Constitutional Court would have been a positive step in this regard. It is hoped that the Slovenian government will be able to produce an alternative property tax reform that achieves the same policy objectives while satisfying legal requirements.

Slovenia's corporate income tax (CIT) system has seen important changes in recent years. Its statutory CIT rate of 17% is the second lowest in the OECD, which provides strong incentives for firms to invest in Slovenia. The Slovenian government's decision not to reduce the CIT rate further to 15% (as had been planned) is sensible, as there would have been diminishing returns. Slovenia's challenge now is to ensure that its CIT base is sufficiently broad and neutral. The recent decision to eliminate preferential CIT treatment for the Koper and Maribor economic zones is sound and should be followed up by an evaluation of other targeted CIT incentives.

Aligning tax rates on different forms of energy

Households and firms should make decisions about consumption and production on the basis of market prices, including taxes that reflect the social costs of environmental damage. In 2012, Slovenia's revenues from environmentally-related taxes amounted to 4% of GDP, the highest ratio in the OECD. Nevertheless, as in other countries, effective tax rates vary substantially across different forms of energy. Tax rates on transport fuel are significantly higher than those on heating and process use and on electricity, and those on diesel remain well below those on gasoline in terms of both energy content and carbon dioxide (CO₂) emissions.

Key OECD recommendations

- **Reduce marginal tax rates on labour income** in a revenue-neutral manner.
- **Curtail tax expenditures and the use of reduced VAT rates** in an equity-friendly manner.
- **Increase tax rates on immovable property.**
- **Align effective tax rates on different forms of energy to reflect environmental damage.**

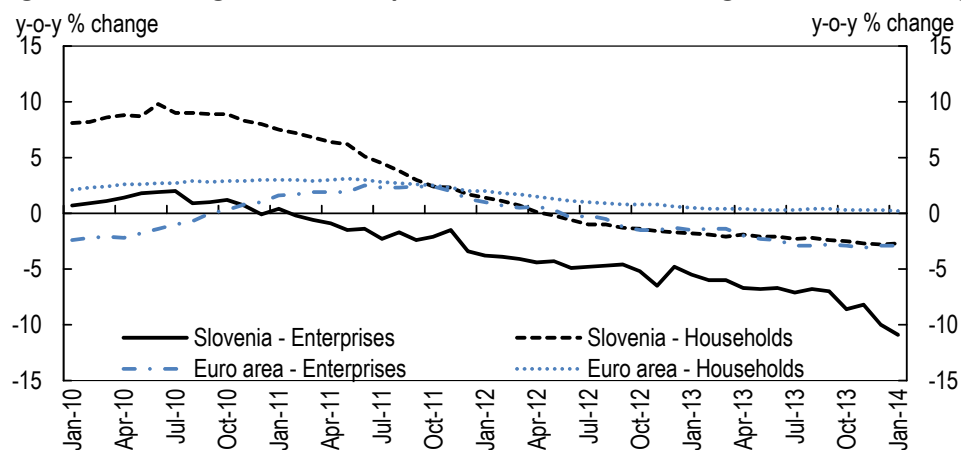
8. Restoring the financial system to health and deleveraging the corporate sector

The restructuring of the Slovenian financial system has started in earnest. Major state-owned banks have been recapitalised several times, most recently in December 2013, at a cost of 9% of GDP. The transfer of impaired loans to the Bank Asset Management Company (BAMC) has begun, paving the way for corporate sector deleveraging and restructuring. Yet, there is still a large corporate debt overhang while some banks are still undercapitalised. Weak equity markets and resistance to privatisations are hindering foreign direct investment, which would help smooth corporate deleveraging and further consolidation of banks' balance sheets.

A boom-bust credit cycle has left a highly-leveraged corporate sector and impaired loans

The unwinding of the lending boom has led to a high proportion of non-performing loans (NPLs) – 13.4% of total loans by the end of 2013, most of which are in the non-financial corporate sector, as household indebtedness is low. NPLs are highest in the large state-controlled banks, pointing to governance problems. The deterioration in asset quality has left Slovenian banks poorly capitalized and ill-equipped to extend further credit to the private sector, holding back investment and consumption (Figure 12). The debt overhang is still large. Although the debt-to-GDP ratio of Slovenian non-financial corporations is close to the OECD average, the debt-to-equity ratio is among the highest, at around 130% in 2013.

Figure 12. Credit growth to the private sector has been negative and declining



Source: European central bank statistical data warehouse, Bank lending survey

The results of the Asset Quality Review (AQR) and Stress Tests of 8 Slovenian banks announced in December 2013 showed that under the adverse scenario, total capital needs of banks stood at EUR 4.8 billion (about 14% of GDP). Of this, the three major state owned banks accounted for EUR 3 billion (about 9% of GDP). They were recapitalised accordingly. The transfer of their bad assets (EUR 4.5 billion valued at about EUR 1.7 billion) to the Bank Asset Management Company (BAMC) has started in exchange for state-backed bonds issued by BAMC. This was preceded by a liquidation of two small insolvent banks. While these actions pave the way for restructuring and deleveraging of the corporate sector and banks,

credit activity is unlikely to recover rapidly without additional capital and swift deleveraging and restructuring of enterprises.

Deleveraging in banks and the corporate sector

In the corporate sector, debt reduction has started but has been so far mainly driven by a decline in borrowing rather than bringing in fresh equity. Successful deleveraging of the corporate sector will eventually improve bank balance sheets. The banking sector also needs to improve operational profitability by increasing efficiency and rationalising costs and further consolidation in the sector is expected in the future.

A new legislative framework for corporate restructuring was introduced in December 2013 to address long in-court insolvency procedures that reduced recovery rates, and late initiation of insolvency procedures. The new framework provides for preventive restructuring of viable companies that could become insolvent within a year. The authorities should closely monitor implementation. Improving institutional capacity by training judges and insolvency administrators would further promote successful implementation.

Corporate deleveraging would also be enhanced by attracting equity through privatisation and entry of foreign investors. Foreign direct investment has been low and public ownership remains high in Slovenia, limiting the scope of the equity market to finance the economy. The government is committed to continue with planned privatisations of major banks. In addition, the government should draft a clear asset management strategy for state-owned enterprises supported by a well-defined distinction between strategic and non-strategic holdings.

Enhancing bank supervision

New amendments to the Banking Act adopted in December 2012 entrusted Bank of Slovenia with additional resolution powers. New legislation in 2014 will introduce capital shock absorbers, enhance bank governance requirements, and improve transparency of bank operations through additional disclosure and assessment of systemic risks, in line with EU directives and international standards.

Poor credit management by banks and insufficient supervision in preventing a too high risk concentration in the construction sector and financial holdings contributed to the crisis. The Bank of Slovenia has a credit registry and should share this information with banks to alleviate informational asymmetries between banks and borrowers. The Bank of Slovenia should also provide more up-to-date information on its webpage to improve market discipline and confidence.

Key OECD recommendations

- **Privatise state-owned banks without retaining blocking minority shareholdings.** The Bank Asset Management Company could be strengthened by bringing in private investors and extending its five-year mandate.
- **Enhance corporate deleveraging by raising equity through privatisation and attracting foreign investors,** thus strengthening also corporate governance.
- **Closely monitor the implementation of the new insolvency regulation.** Improving institutional capacity by training judges and insolvency administrators would further promote the successful implementation.
- **Require the Bank of Slovenia to share information from its credit registry with banks** and enhance its transparency.

9. Greening the Economy

Responding to growing pressures on its natural resources, Slovenia has advanced with environmental policy reforms over the last decade. However, more progress is needed to strengthen environmental considerations in economic and structural policies. A number of challenges stem from Slovenia's highly decentralized governance system and the lack of green private investment.

Integration of environmental considerations in economic and structural policies

In recent years, Slovenia has taken important measures to streamline the planning and permit system for transport, energy and environmental infrastructure and to promote renewable energy sources. But despite the inclusion of environmental issues in Slovenia's Development Strategy 2005-13 and the 2010-13 Exit Strategy, their implementation has not effectively integrated environmental considerations into economic development priorities. The main constraint has been compartmentalisation of planning and implementation within individual government agencies due to a lack of inter-ministerial co-operation. Producing a green growth indicators report could provide an objective basis for charting progress in Slovenia.

Recent events have also reminded the need for coherent policy action to strengthen the economic resilience to meteorological, hydrological and climatic events. The economic costs of the early 2014 floods, sleet and heavy snow amounted to EUR 429 million – taking a heavy toll on forestry (EUR 214 million in damages) and infrastructure systems (EUR 157 million in damages to energy, rail, road and water infrastructure).

Improving the environmental dimension of spatial planning

A number of challenges stem from Slovenia's highly decentralized governance system combined with limited controls on, and co-ordination of, local development. Progress has been made among municipalities to adopt joint approaches for tackling local issues like air pollution and waste management. However, the considerable autonomy of municipalities and the absence of a regional administrative level have widened the governance gap between the national and local levels. Combined with major investments in road construction, it has locked the transport system into a highly carbon-intensive pattern that will take time to change, and contributed to the emergence of air pollution hot-spots in some urban centres. Lack of appropriate land use planning and a high rate of international transit road traffic have reinforced the environmental impact of the transport sector.

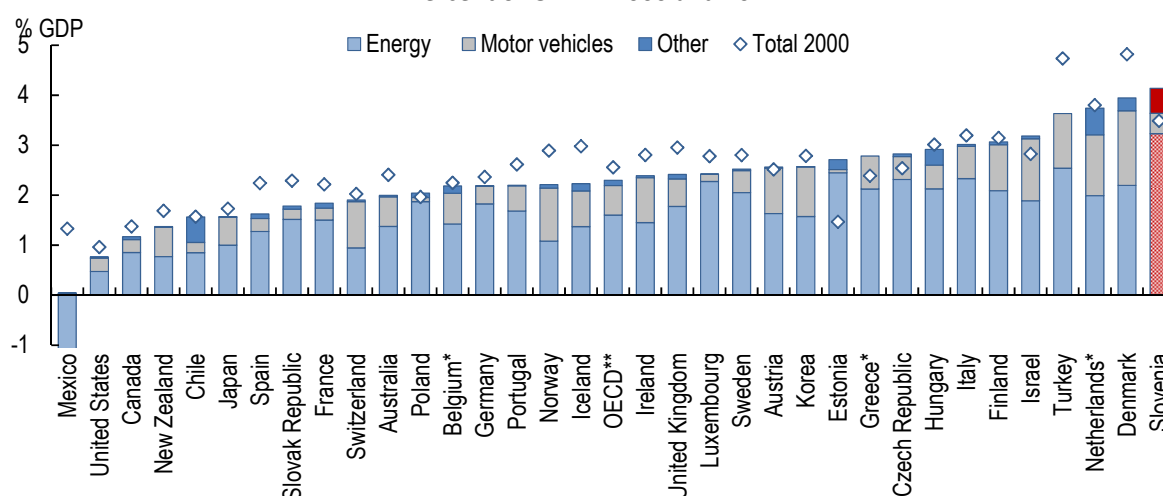
Financing green investment

Achieving ambitious climate change and environmental goals will require a large shift in private capital from polluting to clean technologies and green infrastructure. First, strengthening innovation, including environmental innovation, will be an important part of providing viable technological solutions to enhance competitiveness, and Slovenia has taken a number of steps in this direction. The outputs of the country's environmental innovation system, when measured in terms of number and growth of total patent applications, are relatively weak compared to OECD countries (i.e. Slovenia's 7.3% share in total patents compared to average OECD share of 10.7% over 2009-2011). The public sector accounts for most of the research effort, partly because of the predominance of small and medium sized enterprises, which generally invest less in R&D than larger firms.

Second, there is an urgent need to mobilise green private investments. Thus far, the EU has been an important source of finance for investment in environmental infrastructure in Slovenia. However, in the light of recent EC's allegations of the system's inefficiency with management of funds, Slovenia's future absorption of EU funds is in peril. The decentralisation of responsibilities to local communities also makes it difficult to realise economies of scale for environment-related infrastructure investment. As an asset class, green infrastructure receives little attention from long-term investors, in part because of uncertainty regarding public policy and the lack of stable and coherent mechanisms to support strategic investments in green infrastructure.

Finally, effective carbon pricing has to be the cornerstone of an effective green growth strategy. While Slovenia has the biggest revenues from environmentally-related taxation among OECD countries (4.1% of GDP in 2012; Figure 13), there is a revenue-raising potential from broadening its base towards non-energy taxation. Further, diesel is taxed at a lower rate than petrol, which does not reflect the greater environmental externalities of diesel.

Figure 13. Revenues from environmentally related taxes
Percent of GDP in 2000 and 2012



Note: * 2011 data; ** refers to OECD simple average.

Source: OECD/EEA database on instruments used for environmental policy.

Key OECD recommendations

- **Strengthen environmental considerations in economic and structural policies**, for example, by emphasising “green growth” in the new Development Strategy.
- **Improve the environmental dimension of spatial planning.** A comprehensive strategy is needed to effectively integrate transport, environmental and land use policies at the national level; accompanied by co-ordinated actions by municipalities.
- Pursue an integrated approach to green investment policy to **catalyse and scale up private investment.** Examine how the government can help to improve the risk-return equation for the private sector and draw capital market investment into green projects, for instance through better vehicles and de-risking techniques.

Further reading

OECD (2011), OECD Territorial Review, Slovenia

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