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**Chapter III: Development of the Financial Sector and Analysis of Financial Flows**

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***Fiscal development and policy***



## Summary

In 2007, the fiscal consolidation in most EU Member States was the fastest in recent years against the background of good cyclical conditions. The general government deficit has reached its lowest level in the entire EU area (0.9% of GDP) and the euro area (0.6% of GDP). The most significant contribution to this reduction was made by countries indicating deficits above the reference value of 3% of GDP. Due to a primary surplus increase and favourable nominal GDP growth rate, government debt has also declined the most so far. In the euro area, it has fallen below the reference value (58.7% of GDP), while in the EU it is slightly higher (66.2% of GDP). The reduction in government deficits and government debt was in general greater than envisaged in strategic budget documents, largely because of favourable macroeconomic conditions.

In Slovenia the lowest shares of general government deficit and general government debt in GDP were reached after 2000. Last year, the general government position was close to being in balance (-0.1% of GDP). Total nominal revenues increased significantly more in comparison to total expenditure, and growth in both categories was lower than GDP growth. General government revenue as a share of GDP declined by 0.9 percentage points to 43.2%. As expected, revenue growth was slightly slowed by the introduction of tax reform, but due to favourable macroeconomic developments, tax revenues have been higher than planned. The reduction in the share of general government expenditure has also been the highest thus far. After a reduction in the past four years by approximately 0.5 p.p. in relation to the preceding year, general government expenditure decreased by 2 p.p. to 43.3% of GDP last year. The share of social transfers declined most, due to the introduction of a uniform inflation indexation mechanism, and because of the decelerated growth rate in the number of employees and slow growth of wages per employee in the public sector, the share of compensation of employees was also significantly lower. The accelerated reduction in the government deficit has contributed to a reduction in general government debt. Due to the replacement of expensive forms of borrowing with cheaper alternatives and early debt repayment, and due to further effective interest rate reduction, the consolidated general government debt in GDP has reached the lowest level to date, 24.1% of GDP. The relative share of guarantees has been increasing, while the shares of guarantees called have become relatively smaller.

The cyclically adjusted deficit decreased by 0.5 p.p. last year and exceeded the actual deficit by 0.4 p.p. Despite the significant improvement in the nominal fiscal position, most EU Member States have not fulfilled their plans regarding structural deficit reduction. In Slovenia, deficit reduction was faster than envisaged in the amendment to the Stability Programme dating from the end of last year, according to which Slovenia should reach a balanced fiscal position by 2010. Also in compliance with the provisions of the medium-term budget objectives within the Stability and Growth Pact was the improvement in the cyclically adjusted deficit, which last year declined by 0.5 p.p. according to recent estimates but was still higher than the actual deficit.

In 2007, fiscal policy kept a counter-cyclical orientation and became restrictive. Considering changes in the output gap in the last year, cyclically adjusted deficit reduction means that fiscal policy was counter-cyclically oriented. An improvement in the cyclically adjusted deficit in the first year after integration in

the EMU meant an appropriate fiscal policy response from the point of view of its stabilising role.

The preservation of the long-term sustainability of public finance remains a key fiscal policy challenge. In the case of the same parameters of systems of social protection and economic policy, the general government debt in Slovenia would start to increase after 2015 due to the rapid increase in the number of older people indicated by demographic projections. Due to an expected rise in general government expenditure related to ageing, which will increase pressure on public finance in the next decades, the search for solutions for long-term fiscal sustainability is the key challenge of fiscal policy.

For sound public finance, progress in implementing structural changes, in addition to budget consolidation, is of key importance. Within the strategic framework of the implementation of EU economic policies, public finance quality is becoming an increasingly important factor for the provision of conditions for long-term economic growth and the sustainability of public finance. The quality of public finance is determined by a modern institutional framework, with a comprehensive legal basis and budget procedures, clearly defined goals and fiscal rules, as well as instruments for monitoring and measuring the efficiency of general government revenue and expenditure. The conceptual basis of public finance quality analysis is in preparation; at EU level, the first foundations were established with the multi-dimensional framework proposed by the European Commission.

Among the measures directed towards gradually strengthening the development role of fiscal policy in Slovenia, tax reform was adopted with the aim of increasing the competitiveness of the economy. The tax changes introduced have generally reduced tax burdens. Due to the amended income tax legislation and gradual abolition of the payroll tax, the burden of taxes and contributions on wages has been alleviated. The change in the tax scale has mostly favoured taxable persons in the lowest and highest income brackets. On the other hand, estimates of the results of tax reform on the corporate income tax – which reduced the general tax rate but made the regime of tax relief stricter – show that the effective tax rate increased and therefore the burden on the economy increased. The tax burden on the economy continued to decline because of the further abolition of the payroll tax.

Comprehensive measurements of the efficiency and effectiveness of general government expenditure is impeded by methodological deficiencies, but analyses of the efficiency of social expenditure and state aid show effects. The available indicators show that social expenditure achieved its goals: on average, Slovenia spends relatively little for social security compared to other EU Member States. Slovenia has lower administrative costs for social expenditure management, but at the same time also has a lower at-risk-of-poverty rate and income inequality. The analysis of state aid efficiency and its impact on the competitiveness of the economy revealed that aid intended for small or medium-size enterprises, research and development and employment incentives are efficient. Aid for other purposes is less efficient (training, regional goals) or inefficient (rescue and restructuring, special sectoral aid). Otherwise, efficient purposes could enable the achievement of the set objectives on a much larger scale if we did not pursue the goal of "saving" less successful companies, but allocated aid based on the criterion of



"additionality" to recipients who could achieve the highest possible effects. Since aid is highly concentrated, it compromises competition in the market and their fragmentation indicates that in the light of expenditure and costs they are above average.

## Introduction

*Since integration in the Economic and Monetary Union (EMU), fiscal policy and incomes policy have had a greater stabilising role.* Already in the first year after introduction of the euro, when in favourable cyclical conditions pressures on the internal and external balance of the economy began, appropriate fiscal policy was one of the most important economic issues.

*The strategic framework of economic policy implementation in the fiscal policy of the EU determines stabilisation tasks, as well as development roles.* Sound and transparent public finance and good fiscal policy enabling the more efficient use of resources have proved to be the key conditions for sustainable economic growth. Due to requirements for the coverage of more pronounced liabilities related to unfavourable demographic trends, but in respect of an unchanged commitment to reduce the share of public spending and general government deficits, public finance quality improvement is becoming a broader economic issue. Institutional structure, procedures and rules focused on results and effects (and not on sources used) have become more important.

*In this year's fiscal chapter, we therefore deal with two views of fiscal policy: stabilisation and developmental.* The first part is intended as a review of fiscal development and policy in the last period. In the first section, public finance development in the EU is presented, and the second section deals in detail with the development of budget aggregates and flows in Slovenia, including an analysis of cyclical and structural factors and sustainability elements. The third section is new, and presents a methodological and analytical basis for the integral monitoring of public finance quality. Key findings and recommendations resulting from it are enumerated in the fourth section.

## 1. Fiscal development and policy in the European Union<sup>1</sup>

*In 2007, the budget deficit in the euro area and the EU reached the lowest level since the early 1970s.* The "record-low" level of the deficit in the euro area (0.6% of GDP) and the EU (0.9% of GDP) was achieved thanks to both favourable economic conditions and discretionary efforts. Many countries have used a part of the revenue windfalls to reduce taxes or increase expenditures.

*The decline in the deficit in the euro area and the EU in 2007 reflects a relatively broad-based trend across countries with a significant contribution from countries with excessive deficits.* While progress is not homogeneous across countries, the effort was particularly notable in countries that in the past had breached the 3% of GDP threshold of the Treaty.<sup>2</sup> The fiscal position of twelve

---

<sup>1</sup> This chapter is based on contributions from Martin Larch (advisor, BEPA) and Marko Mršnik (Standard & Poor's)

<sup>2</sup> In January 2006, twelve countries were still subject to the excessive deficit procedures (EDP) of the Stability and Growth Pact (SGP). Two years on, all euro area countries succeeded in bringing their deficits below the threshold and only Hungary remains in EDP. A new procedure was opened for the UK on 8 July.

Member States – two more than a year before – is in line with or exceeds their medium-term objective. With the exception of very few countries (Ireland, France and the United Kingdom) the 2007 deficit outcomes outperformed the targets presented in the 2006/07 updates of the Stability and Convergence Programmes (see Box 1). Particularly important progress was made in Germany, where the nominal deficit fell by 1.6% of GDP and a balanced budget was achieved.

*Contrary to the adjustment strategy, actual budget implementation departed from planned expenditure reductions.* Following a recurrent pattern observed in the past, the majority of Member States reported expenditure slippages (including additional discretionary spending), which could be mostly covered by higher-than-expected revenues. This outcome contrasts with the policy advice of the Council opinions on the 2006/07 updates of the Stability and Convergence Programmes and, for the euro area countries, with the commitments made in the spring of 2007 in Berlin, namely to fully use extra revenues to reduce deficits and debt.

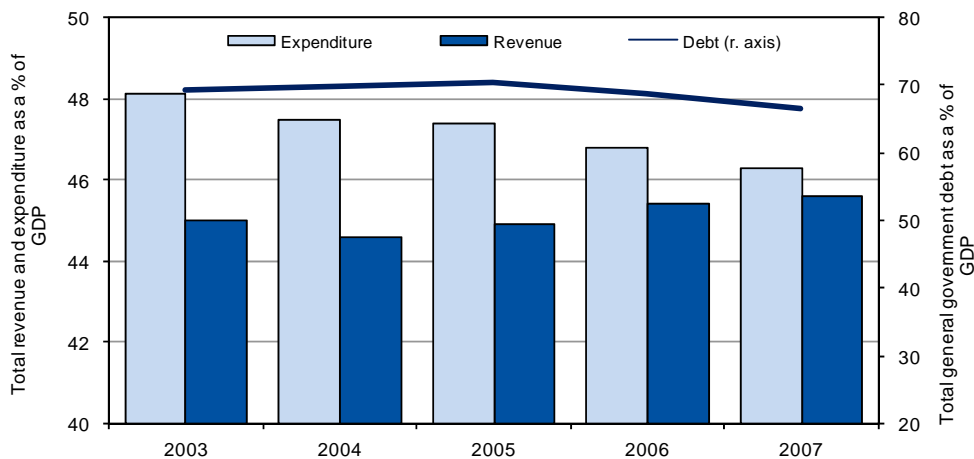
**Table 1: Headline and structural general government balances in the EU**

	Nominal balance (as a % of GDP)					Structural balance (as a % of GDP)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
BE	0.0	0.0	-2.3	0.3	-0.2	-1.1	-0.9	-0.2	-0.6	-0.3
DE	-4.0	-3.8	-3.4	-1.6	0.0	-3.3	-3.0	-2.4	-1.4	-0.3
IE	0.4	1.4	1.6	3.0	0.3	-0.1	2.1	1.3	2.9	0.2
EL	-5.6	-7.4	-5.1	-2.6	-2.8	-5.9	-8.0	-5.7	-3.7	-3.3
ES	-0.2	-0.3	1.0	1.8	2.2	-0.3	-0.2	1.2	2.0	2.4
FR	-4.1	-3.6	-2.9	-2.4	-2.7	-4.0	-3.8	-3.6	-2.7	-2.7
IT	-3.5	-3.5	-4.2	-3.4	-1.9	-5.1	-4.7	-4.5	-2.8	-1.5
CY	-6.5	-4.1	-2.4	-1.2	3.3	-8.1	-4.9	-2.8	-0.7	3.5
LU	0.5	-1.2	-0.1	1.3	2.9	1.2	-0.9	0.4	1.4	2.8
MT	-9.8	-4.6	-3.0	-2.5	-1.8	-6.5	-4.2	-3.8	-2.9	-2.4
NL	-3.1	-1.7	-0.3	0.5	0.4	-2.0	-1.1	0.8	1.1	0.3
AT	-1.4	-3.7	-1.5	-1.5	-0.5	-0.6	-3.1	-0.8	-1.4	-1.0
PT	-2.9	-3.4	-6.1	-3.9	-2.6	-4.7	-4.9	-5.2	-3.2	-2.2
SI	-2.7	-2.3	-1.5	-1.2	-0.1	-1.9	-1.6	-0.9	-1.3	-0.7
FI	2.6	2.4	2.9	4.1	5.3	3.3	2.9	3.7	4.2	4.9
<b>EMU-15</b>	<b>-3.1</b>	<b>-2.9</b>	<b>-2.5</b>	<b>-1.3</b>	<b>-0.6</b>	<b>-3.1</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.2</b>	<b>-0.7</b>
BG	0.0	1.4	1.8	3.0	3.4	0.0	1.0	1.5	2.5	3.1
CZ	-6.6	-3.0	-3.6	-2.7	-1.6	-5.5	-1.3	-3.3	-2.9	-2.3
DK	0.0	1.9	5.0	4.8	4.4	0.9	2.5	5.3	4.1	3.9
EE	1.8	1.6	1.8	3.4	2.8	2.0	1.6	1.2	1.0	1.3
LV	-1.6	-1.0	-0.4	-0.2	0.0	-1.2	-0.8	-0.5	-1.1	-1.4
LT	-1.3	-1.5	-0.5	-0.5	-1.2	-1.9	-2.1	-1.1	-1.0	-1.4
HU	-7.2	-6.5	-7.8	-9.2	-5.5	-6.8	-6.9	-8.6	-9.7	-4.7
PL	-6.3	-5.7	-4.3	-3.8	-2.0	-5.9	-5.9	-4.2	-4.0	-2.5
RO	-1.5	-1.2	-1.2	-2.2	-2.5	-0.8	-1.8	-1.6	-2.7	-3.4
SK	-2.7	-2.4	-2.8	-3.6	-2.2	-1.4	-1.4	-1.0	-3.1	-2.6
SE	-0.9	0.8	2.2	2.3	3.5	-0.2	0.2	1.9	1.5	2.8
UK	-3.3	-3.4	-3.4	-2.6	-2.9	-3.4	-3.7	-3.4	-2.8	-3.0
<b>EU-27</b>	<b>-3.1</b>	<b>-2.8</b>	<b>-2.5</b>	<b>-1.4</b>	<b>-0.9</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.5</b>	<b>-1.0</b>

Source: European Commission

*In 2007, debt reduction continued and largely thanks to an increase in primary surpluses and was coupled with favourable nominal GDP growth.* The debt ratio of the EU as a whole dropped below the 60% of GDP threshold of the Treaty in the euro area; the debt ratio also stayed on a downward trend yet remained six percentage points above the threshold. The reduction in government gross debt levels in percent of GDP was broad-based across countries. Among the ten Member States which in 2006 had recorded a debt ratio of more than 60% of GDP, there were only two – France and Hungary – whose government debt increased in 2007. With a debt ratio of 104% of GDP, Italy remains the country with the highest degree of indebtedness in the Union.

Figure 1: Total general government revenue, expenditure and debt in the euro area



Source: Eurostat

#### Box 1: Factors in the improvement of fiscal positions in the EU

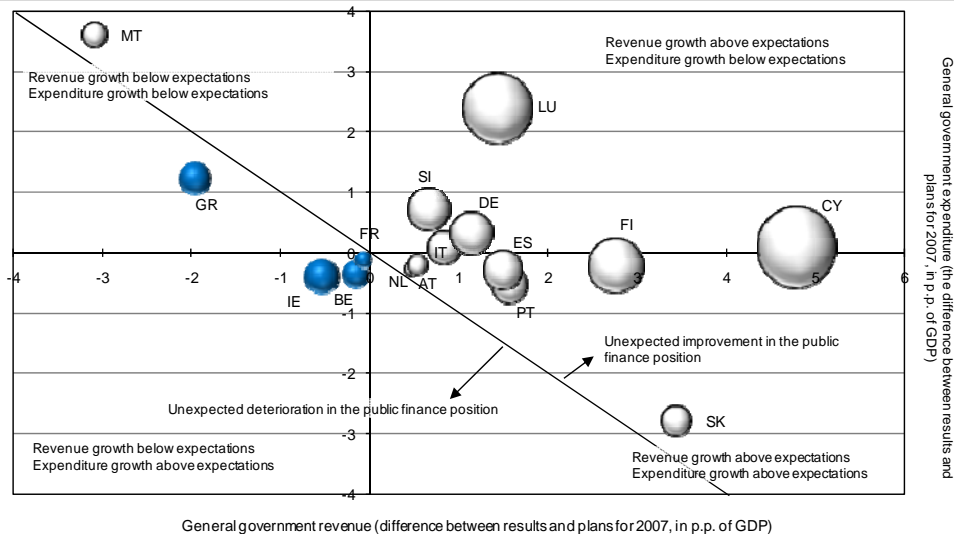
*The improvement of the fiscal position in the EU and in the euro area is due to cyclical as well as structural factors.* Estimating individual factors is difficult due to significant tax elasticity variation. The response of tax revenues to greater economic activity was well above average in several countries in the euro area, because in the past two years revenues have grown faster than nominal economic growth. This was also supported by trends in corporate profits, high oil prices and vigorous growth of domestic demand components (especially private consumption and investment). At the same time, they are a reflection of increased financial and non-financial asset values resulting from growth in the equity and housing markets.

*A comparison of budgetary plans and results for 2007 shows that the euro area countries largely underestimated nominal economic growth due to lower than expected real economic growth and inflation.* Comparison of actual results for 2007 with budgetary plans from the Stability and Convergence Programmes dating from the end of 2006 enables an insight into the dynamics of total general government revenues in the past year in relation to original expectations and also estimates the nature of expenditure policies (see Figure 2).<sup>3</sup> The majority of countries managed to achieve a better fiscal position considering their original expectations, but the results are quite diverse in relation to revenue and expenditure components.

<sup>3</sup> Standard & Poor's (2008): Budgetary Developments in Europe: Past Simple, Future Tense.

*Last year, the inflow of funds on the revenue side in all countries, with the exception of Malta and Greece, was significantly higher than envisaged in the Stability and Convergence Programmes from the year 2006.* Some of this positive discrepancy can be explained by the relatively careful forecasts of nominal economic growth and exceeding the tax elasticity assumed in the budgets. Strong economic growth was also reflected in the increase in employment and the reduction in unemployment, which had a positive impact on public finance. In countries where structural measures had been introduced on the revenue side (e.g. tax reform in Slovenia), these measures were successful due to the favourable economic conditions and did not lead to tax revenue reduction.

Figure 2: Comparison of budgetary plans and results for 2007



Source: Stability and Convergence Programmes 2006, Eurostat and authors' calculations  
 Note: The size of the circle represents the deviation of the actual general government balance from the expected balance (based on the Stability and Convergence Programmes).

*The expenditure side is more foreseeable regarding budget plans, since the cyclical component represents a relatively smaller share than on the revenue side.* In general, the monitoring of expenditures has been crucial in the past two years for the improvement of the fiscal position, since revenues were much higher than expected and budgetary objectives could very well be achieved under loosened discipline on the expenditure side. In this way, in some countries general government expenditure increased in relation to plans, despite the favourable cycle.

*Most countries improved their fiscal position through changes on the revenue side.* Figure 2 shows that Cyprus (where revenue growth strongly exceeded planned growth, due to high profits in the financial sector and real estate investments) and Finland (where revenues received a boost from returns on the national pension fund) lead among those countries where an improvement in the fiscal position was above expectations. Both countries achieved improvement through higher than expected revenues. In Slovakia, where revenue growth was also well above expectations (as a consequence of accelerated consumption before the increase of excise duties and taxes announced for 2008), the improvement in the fiscal position was less pronounced since additional consumption occurred at state and local levels at the same time. On the other hand, Slovenia was one of the countries where better improvement in the fiscal position than foreseen in the Stability Programme from 2006 was not exclusively ascribable to revenue growth – which

was above expectations – but also to lower-than-planned expenditure.<sup>4</sup> Expenditure growth was significantly slower than expected in Malta, which managed to reduce the general government deficit more than expected by considerably reducing investment expenditure on having lower revenues than planned (partially also because of insufficient absorption of EU funds). Ireland, Greece and Belgium, on the other hand, recorded an unexpected deterioration in the general government balance in relation to forecasts.

*According to the Commission 2008 spring forecasts, the process of fiscal adjustment observed in the past several years is likely to come to a standstill and to reverse.* The predominant view reflected in the vast majority of public and private macroeconomic forecasts is that in 2008 economic growth is likely to ease. Against the background of less favourable cyclical conditions, sustaining the current trends in public finance will represent the key challenge for fiscal policy in the coming years.

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<sup>4</sup> Among the countries where the improvement of fiscal balance was due to lower than planned expenditure, Luxembourg showed the highest improvement, but the outcome was mainly the result of a data revision from 2005.

## 2. Fiscal development and policy in Slovenia

### 2.1. Budget aggregates of the general government sector<sup>5</sup>

*In 2007, the lowest general government deficit since 2000 was recorded.* The deficit of the general government sector compared to gross domestic product has fallen gradually and stood at 0.1% of GDP in 2007. In relation to the previous year, the deficit fell by 1.1 p.p., since total nominal general government revenue increased considerably more than total general government expenditure, while growth in both categories lagged behind GDP growth.

*Against the backdrop of strong economic growth, the share of general government total revenue and total expenditure in GDP fell in relation to the previous year.* The share of general government revenue, which has been very stable since 2000 and was on average approximately 44% of GDP, fell by 0.9 p.p. in 2007, and at 43.2% of GDP recorded the lowest level since 1995. The share of general government expenditure after 2001, when it was the highest in the last decade (48.1% of GDP), gradually declined to 43.3% of GDP last year, which was the most significant reduction in relation to the previous year. A considerable reduction in general government expenditure contributed to a significant improvement in the fiscal position in the past year.

Table 2: Revenue, expenditure and balance of the general government sector as a % of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	Change 2006–2007, in p.p.
Total revenue as a % of GDP	43.6	44.1	44.6	44.4	44.2	44.5	44.1	43.2	-0.9
Total expenditure as a % of GDP	47.4	48.1	47.1	47.1	46.5	46.0	45.3	43.3	-2.0
Net lending (+)/net borrowing (-) as a % of GDP	-3.8	-4.0	-2.5	-2.7	-2.3	-1.5	-1.2	-0.1	-1.1

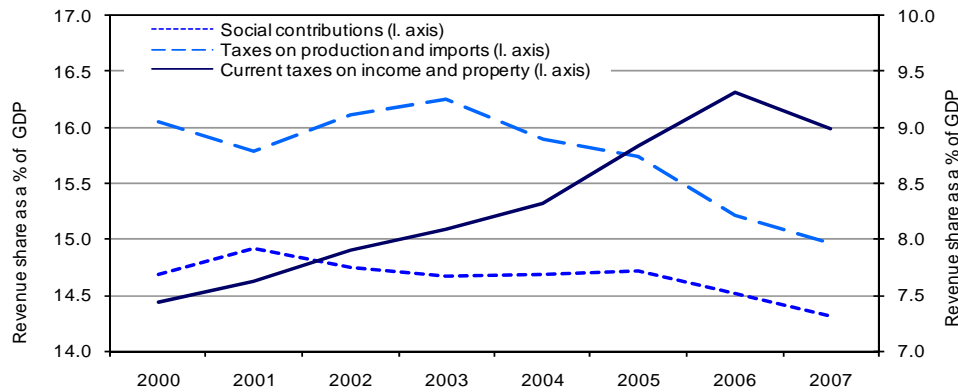
Source: Statistical Office of the Republic of Slovenia (SORS), Main Aggregates of the General Government 2004–2007, 2000–2003 Non-financial sector accounts, calculations by IMAD

*In 2007, growth in general government revenue was slightly slowed by tax reform, but as a result of strong economic activity, tax proceeds were higher than expected.* Last year, more important revenue categories as well as total general government revenue grew at a slower pace than economic activity, which led to a reduction of their share in GDP. Due to the amended tax legislation in the field of personal income tax and corporate income tax (see Section 3.2), the share of current tax on income and property fell by 0.3 p.p.. The share of revenue from social security contributions, which last year grew faster than other government revenue due to an increase in the number of wage earners, was also smaller (by 0.2 p.p.). Because of the effect of gradual payroll tax reduction (see Section 3.2), the share of tax on production and imports also fell (by 0.3 p.p.). The faster growth in accrued excise duties compensated the moderate growth in accrued VAT due to slow real growth in private and government consumption and, to a lesser extent, faster growth of imports of goods and services. Revenues from other current transfers fell as well (by 0.3 p.p.). Only non-tax revenues, namely interest

<sup>5</sup> The analysis enables comparison with the trends in the EU since it is based on the national accounts methodology ESA-95, available for Slovenia from 1995 on. ESA-95 enables a broader view of the economic role of the government as a whole.

receivable (by 0.1 p.p.) and revenue from capital transfers (by 0.2 p.p.), increased their share in GDP.

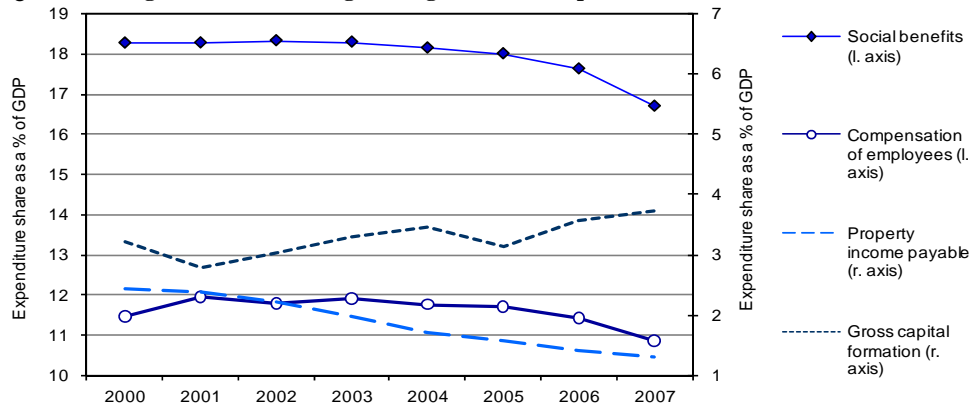
Figure 3: Changes in the shares of revenue items of the general government sector



Source: SORS, Main Aggregates of the General Government, calculations by IMAD

*In 2007, general government expenditure grew significantly slower than in previous years despite favourable macroeconomic conditions, partly also due to expenditure rationalisation.* The total share of general government expenditure in GDP decreased in relation to the previous year by 2 p.p., the sharpest decline after 2001. The share of social benefits in cash suffered the largest reduction (by 0.9 p.p.) due to the introduction of a uniform mechanism for their alignment with inflation (except pensions). The share of compensation of employees also declined considerably (by 0.6 p.p.) due to a decelerated growth rate in the number of employees and slow growth of wages per employee in the public sector in 2007. Compared to 2006, the share in GDP also decreased for intermediate consumption (by 0.3 p.p.) and grants (0.2 p.p.). The share reduction was smaller for interest payments (up to 0.1 p.p.), while the share of other current and capital transfers did not change.

Figure 4: Changes in the shares of general government expenditure items

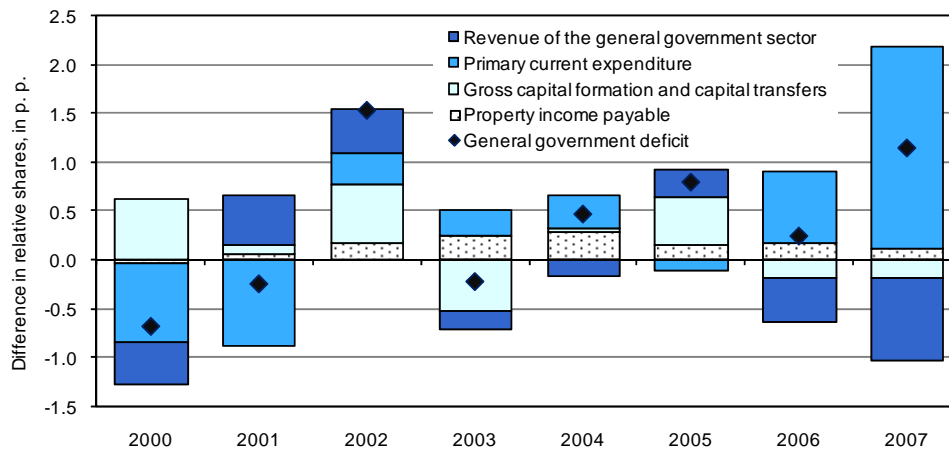


Source: SORS, Main Aggregates of the General Government, calculations by IMAD



**Lower general government expenditure made a crucial contribution to the highest recorded deficit reduction since 2003.** Primary current expenditures decreased by 2.1 p.p. and property income payable by 0.1 p.p., while capital transfers and investment increased by 0.2 p.p., indicating more growth-oriented general government expenditures in 2007. General government revenue also decreased last year, which meant a lowering of the tax burden (see Section 3.2), but also limited the general government deficit reduction. Since expenditure reduction in the general government sector was significantly higher compared to revenue reduction, the general government deficit nevertheless decreased considerably.

Figure 5: Contributions to changes in the general government deficit



Source: SORS, Main Aggregates of the General Government, calculations by IMAD  
Note: Positive change in a relative deficit share means a deficit reduction in the current year compared to the previous year. An increase in expenditure and a decrease in revenue are shown as a negative value, since they contribute to a widening of the deficit.

**Last year, as well as in the previous year, the general government deficit was generated mainly at the central government level.**<sup>6</sup> The deficit fell from 1.2% to 0.3% of GDP compared to the previous year. Local government units concluded 2007 with a balanced position, while social security funds had a surplus of 0.2% of GDP.

Table 3: Net borrowing of the general government sector by subsector (as a % of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
Net borrowing of the general government sector (deficit)	-3.8	-4.0	-2.5	-2.7	-2.3	-1.5	-1.2	-0.1
Of which:								
Central government	-3.3	-3.8	-2.2	-2.5	-2.1	-2.2	-1.2	-0.3
Local government	0.0	0.0	-0.2	-0.1	-0.1	0.0	-0.1	0.0
Social security funds	-0.5	-0.2	-0.1	-0.1	-0.1	0.8	0.1	0.2

Source: SORS, Main Aggregates of the General Government 2004–2007, 2000–2003 Non-financial sector accounts, calculations by IMAD

<sup>6</sup> According to the Standard Classification of Institutional Sectors (SKIS), central government level includes direct budget users, government funds and other central government units.

## 2.2. Cyclical and cyclically adjusted general government balance

*Based on a breakdown of budget aggregates into cyclical and cyclically adjusted components, the orientation of fiscal policy can be estimated.* The general orientation of fiscal policy in relation to the response of revenue, expenditure and consequently fiscal balance to changes in the economic cycle is more evident once aggregate developments are cleared of cyclic effects.<sup>7</sup> The cyclically adjusted or structural balance<sup>8</sup> shows what kind of budgetary results could be achieved simply through the operation of fiscal policy measures, i.e. without the influence of cyclical conditions.<sup>9</sup> Comparison of the change in the cyclically adjusted balance and output gap between individual years indicates the orientation of fiscal policy. The reduction of the cyclically adjusted deficit in a period of accelerated economic growth thus indicates the restrictive orientation of fiscal policy.

*In 2007, the cyclically adjusted deficit halved and was 0.4 p.p. higher than the actual deficit.* Since 2000, together with the actual deficit, the cyclically adjusted deficit has also been gradually falling with the cyclical variation in economic activity. According to available estimates, the output gap closed in 2007, when actual economic growth exceeded potential growth. The improvement in the fiscal stance was ascribable to cyclic as well as structural factors. Apart from a reduction in the relatively expressed nominal deficit, the cyclically adjusted deficit, reflecting the effects of structural adjustments, also declined (by 0.5 p.p. compared to the previous year). We estimate that with the positive output gap, last year's actual deficit (-0.1% of GDP) was lower than the cyclically adjusted deficit (-0.45% of GDP). Slovenia therefore reached its mid-term fiscal objective – expressed as a structural or cyclically adjusted deficit – set at 1% of GDP (for the concept and recent developments regarding mid-term fiscal objectives see Box 2).

Table 4: Actual, cyclical and cyclically adjusted general government balance, as a % of GDP

	Output gap	Actual balance	Cyclical balance	Cyclically adjusted balance	Primary balance
2000	0.6	-3.8	0.2	-4.0	-1.3
2001	-0.4	-4.0	-0.2	-3.9	-1.6
2002	-0.7	-2.5	-0.3	-2.2	-0.3
2003	-1.9	-2.7	-0.8	-1.9	-0.7
2004	-1.7	-2.3	-0.7	-1.5	-0.5
2005	-1.9	-1.5	-0.8	-0.6	0.1
2006	-0.5	-1.2	-0.2	-1.0	0.2
2007	0.9	-0.1	0.4	-0.5	1.2

Source: Mičković, S. (2008): Assessment of the fiscal stance in Slovenia

Note: <sup>1</sup>In accordance with the methodology of the European Commission, estimates of cyclically adjusted deficit derive from the calculations of output gap based on the production function. This asserted itself as the most appropriate method of detecting potential GDP growth and the elasticity of expenditure and revenue to changes in the business cycle, despite some methodological deficiencies (e.g. as regards uncertain estimates of capital stock).

<sup>7</sup> Cyclicity is measured by the difference between actual and potential output, i.e. the output gap.

<sup>8</sup> Structural balance might differ from the cyclically adjusted balance for the effects of exceptional factors (e.g. the EU presidency). Our analysis is based on the calculations of a cyclically adjusted balance.

<sup>9</sup> The cyclically adjusted balance shows the fiscal balance under the assumption that actual GDP growth equals potential growth.

### Box 2: New medium-term fiscal objectives within the framework of the renewed Stability and Growth Pact

In the run-up to the EMU, the Stability and Growth Pact was adopted in 1997 (hereinafter: Pact), which represents a mechanism for the coordinated implementation of fiscal policies of Member States with the common currency. Since its introduction, it has been obvious that the Pact has deficiencies, which became very obvious with the enlargement of membership and the growing differences between Member States. A decision on reforming the Pact was adopted which should enable more efficient coordination of fiscal policies and discourage countries from violating the provisions of the Pact.

The reform of the Pact, which was formally endorsed at the meeting of the European Council in March 2005,<sup>10</sup> was focused on increasing the economic rationale of fiscal rules<sup>11</sup> and commitment to compliance at national level. The new Pact therefore acknowledges the greater importance of economic conditions in procedures, monitoring the achievement of fiscal objectives and reduction of fiscal deficits in favourable economic conditions, while at the same time putting more emphasis on the level of public debt and sustainability of public finance. The reform enabled better consideration of actual economic conditions and structural reforms in individual countries. The changes introduce the implementation of differentiated medium-term fiscal objectives and tolerance allowed on the route to adjustment. These should be implemented gradually, in two steps. In the first step, the Member States presented their medium-term fiscal objectives<sup>12</sup> for the first time in their Stability and Convergence Programmes for 2005, where they already took into consideration the lowest benchmark reference, which represents the minimum requirement as to the value of the medium-term objective.

The second step anticipates that differentiated medium-term fiscal deficits for each country will be calculated taking into consideration implicit liabilities.<sup>13</sup> As opposed to the calculation in the first step, which only considers past trends, the calculation approach in the second step is focused more on future trends, which is important in ensuring and preserving the medium- and long-term sustainability of public finance. The European Commission submitted a proposal for the methodology of calculating medium-term fiscal objectives to Member States for discussion. The quantitative assessment of the sustainability of public finance and setting medium-term fiscal objectives on the basis of sustainability criteria should be supplemented by a qualitative assessment which will additionally consider the reliability of projections for expenditure linked to ageing, as well as the complete scenario of future economic trends based on the envisaged economic policy measures.

The European Commission established three basic approaches for the calculation of medium-term fiscal objectives, which are briefly described below as approaches A, B and C (for details see Appendix). The first two are entirely based on synthetic indicators of long-term fiscal sustainability, while the third approach allows for the inclusion of sustainability components that are not sufficiently included in the established indicators.

<sup>10</sup> Legal basis: Council Regulation EU 1055/2005 and Regulation 1056/2005.

<sup>11</sup> Quality analysis of fiscal rules according to the Kopits-Symanski criteria shows that the reform brought positive changes, but the complexity of rules and their consistent and objective assessment is becoming a problem; at the same time the issue of feasibility of sanctions remains problematic (Bednaš, 2006).

<sup>12</sup> Calculations were prepared in compliance with the methodology, which takes into consideration the level of public debt, potential economic growth and safety margin.

<sup>13</sup> Implicit liabilities comprise those liabilities which arise in the future and are linked mainly to population ageing, and contingent liabilities which do not necessarily have a basis in legislation or a contract but are part of the programme requirements of influential interest groups.

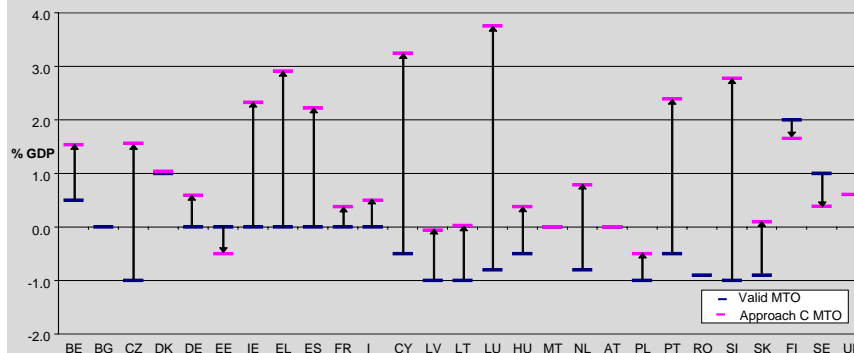
*Approach A* is based on frontloading the adjustment to the medium-term objective. The new medium-term objective for Slovenia, calculated according to this approach, is a general government surplus of 6.1% of GDP, which with regard to the existing framework of public finance is a completely unrealistic objective of fiscal policy. Compared to the existing medium-term objective, the new objective calculated on the basis of this method requires a considerably more ambitious fiscal policy, also for other Member States.

*Approach B* is based on the principle of gradual adaptation and allows taking into consideration different fiscal positions in individual Member States. The new medium-term objective for Slovenia, calculated on the basis of approach B, is a general government surplus of 2.8% of GDP.

*Approach C* is based on the assumption that the process of fiscal adjustment in an individual Member State depends on its specific economic situation and allows that, in addition to the current level of government debt, other sustainability factors are also taken into consideration. In the calculation of the new medium-term objective for Slovenia, the European Commission has not presumed any other important sustainability factors; therefore, the medium-term objective calculated on the basis of this approach is the same as for Approach B, i.e. a general government surplus of 2.8% of GDP.

The new medium-term fiscal objectives are, regardless of the approach used, higher than the current ones for most Member States.

Figure 6: Valid medium-term fiscal objectives (MTOs) and proposals for new objectives as per Approach C



Source: ECFIN/C2/REP/52865/07 REV

Each of the proposed approaches is debatable, in view of the fact that in choosing a reference value it places countries with a low government debt level, such as Slovenia, in an unequal position with regard to countries with high debt levels. This could be eliminated by taking into consideration the difference between the existing government gross debt level and the allowed maximum level of government debt. Countries with high indebtedness should therefore have a higher primary balance than those with lower debt levels. The proposed approach puts more emphasis on the current fiscal position, with a high probability that the contingent liabilities will become real. In addition to fulfilling the enforced requirements, it would also enable avoiding bad allocations of funds in the medium-term arising from considerable uncertain liabilities in the future. The new medium-term objective for Slovenia, calculated on the basis of this approach, would not be higher than 1% of GDP, taking into account the government debt outstanding in the ensuing years.

However, such an approach could not eliminate other deficiencies of the approaches described above, in particular:

- the excess weight of actual liabilities at the expense of contingent liabilities;
- the great uncertainty of expenditure assessments related to ageing;
- the reduction of contingent liabilities arising from reforms of social security systems but at the expense of endangering well-being, which increases other contingent liabilities.

Setting up conditions for the long-term sustainability of public finance should begin immediately and be implemented gradually. In view of feasibility, the key factors are especially:

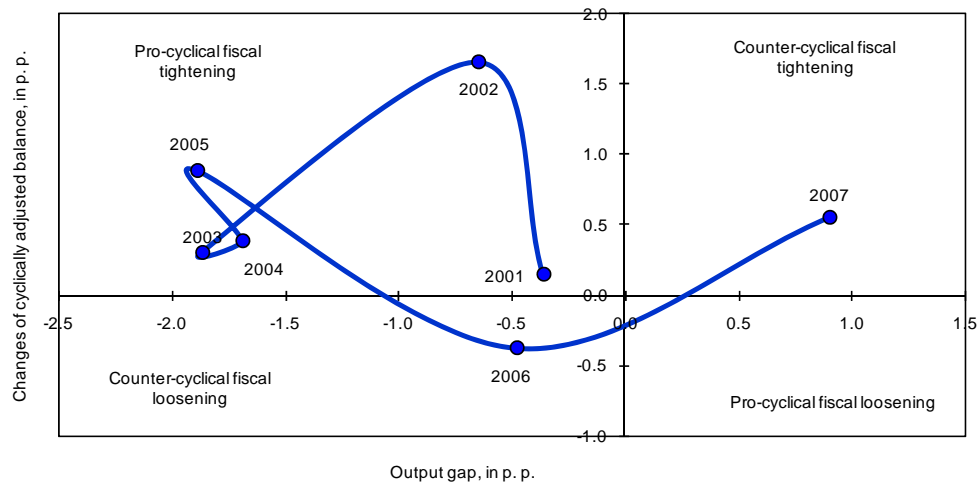
- reducing the period for which we establish contingent liabilities for the needs of determining medium-term objectives to, for example, ten years;
- adjusting the medium-term objectives for the period of ten years every four years;
- determining medium-term objectives which enable compliance with the reference value at 3% of GDP.

***Comparison of the dynamics of the cyclically adjusted deficit and output gap shows pro-cyclical or counter-cyclical orientations of fiscal policy.*** Changes of the cyclically adjusted balance in consecutive years indicate the orientation of fiscal policy, i.e. fiscal impulse. Comparing it to the output gap in the same period, which shows changes in the business cycle, we can estimate the cyclical dimension of fiscal policy, i.e. fiscal stance. In Figure 7, we can define four quadrants with regard to changes in fiscal impulse and output gap, which determine the fiscal stance. Fiscal policy is counter-cyclical if the combination of both parameters lies in the first or third quadrant. This means that fiscal policy, when economic growth falls below its potential, responds expansively; when actual growth exceeds the potential growth of GDP, it responds restrictively. The combination of both parameters in the second or fourth quadrants indicates a pro-cyclical fiscal policy, meaning that when economic growth falls below potential, the fiscal policy responds restrictively; when actual growth exceeds the potential growth of GDP, fiscal policy is also expansive. A pro-cyclical orientation means that fiscal policy does not allow for automatic stabilisers to operate, which results in, for example, expenditure changing in accordance with changes in economic growth, and not as planned. This means that in the case of economic growth which is higher than initially planned, pro-cyclical budget revenues are used to finance reductions in taxes and increased expenditure, and not to reduce the deficit.

***In 2007, fiscal policy was counter-cyclically restrictive for the first time since 2000.*** Based on a comparison of dynamics of the cyclically adjusted balance and output gap in the period 2000–2007, we assess that fiscal policy in the first five years was restrictive, but pro-cyclical (see Figure 7, where in presenting the transition of the cyclical orientation of fiscal policy from the second to the first quadrant, the points are denser in the second quadrant). In the period 2001–2005, when actual economic growth was lower than its potential, the trend of fiscal expenditure followed the macroeconomic situation. In the period when the main priority of economic policy was to fulfil the requirements to adopt the euro, fiscal policy restricted the activity of fiscal stabilisers. The general government deficit therefore remained below reference value, but fiscal policy acted restrictively. Since 2006, when the output gap started to close, fiscal policy has been counter-cyclical. At first it was slightly expansive – the cyclically adjusted deficit of 2006 increased (per available assessments by 0.4 p.p.) – but the improvement last year (by 0.5 p.p.) shows that fiscal policy again became restrictive. The increase of the fiscal impulse

under conditions of a positive output gap was an appropriate response of fiscal policy in terms of its stabilisation role (shift to the first quadrant in Figure 7). The fiscal adjustments were therefore in compliance with the provisions of the Stability and Growth Pact, according to which fiscal policy should be restrictive in conditions of high cycles.

Figure 7: Cyclical orientation of fiscal policy



Source: Mičković, S. (2008): Assessment of fiscal position in Slovenia

Note: Positive fiscal impulse, for example, means an improvement of the cyclically adjusted deficit in the current year in comparison to the previous year. The varying distances of separate points from the axes shows fiscal policy intensity.

***This year, fiscal policy should preserve its counter-cyclical orientation.*** The most recent assessments based on data from the adopted supplementary budget for 2008 indicate that the ratio between actual and cyclically adjusted balance this year will be approximately at the level of last year. With an anticipated reduction in the positive output gap, this means that fiscal policy remains counter-cyclically oriented. At the same time, we may expect that changes in tax legislation<sup>14</sup> will lessen the fiscal impulse; recent assessments show that the cyclically adjusted deficit will improve only slightly, although the output gap will remain positive.

### 2.3. Financial flows between Slovenia and the EU budget

***In 2007, Slovenia was a net contributor of funds to the EU budget for the first time since joining the EU.*** According to the Ministry of Finance, last year the absorption of funds from the EU budget was very modest, and at the same time expenditure from its own traditional resources was higher than expected.<sup>15</sup>

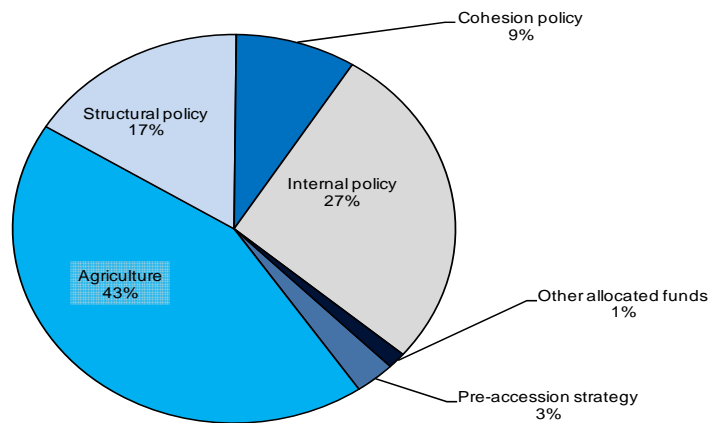
<sup>14</sup> Amendments of laws passed in January this year as part of measures to reduce the consequences of higher inflation on the population's well-being, among other things introduced additional general tax relief in personal income tax for persons with taxable incomes up to EUR 9,000 and increased social transfers.

<sup>15</sup> Traditional own resources (payments originating from customs duties, import duties and special taxes on the import of agricultural products and foodstuffs) are treated as EU budget revenues in the strict sense collected by Member States, whereby they retain a quarter of the funds as reimbursement for collection costs.

Contributions from customs duties<sup>16</sup> were much higher than expected and contributions from VAT were slightly higher, which together greatly exceeded the planned contributions in the budget for 2007. The highest contribution to the EU budget represented contributions based on gross national income with a 55.3% share.

**Total absorption of funds from the EU budget was greatly reduced in 2007.** Last year, the absorption of funds was much lower than expected, especially in the field of structural and cohesion policies, where delays occurred in absorbing funds from the new financial perspective.<sup>17</sup> Until last year, Slovenia was among the most successful new Members, as it utilised almost 70% of the funds to which it was entitled in the previous financial perspective.<sup>18</sup>

Figure 8: Structure of funds allocated from the EU budget to the state budget in 2007



Source: Ministry of Finance

**European Commission data on inflows and outflows of EU budget funds show that last year Slovenia remained a net recipient of funds, but with the lowest surplus thus far.** Funds received from the EU budget last year were again higher than contributions, which represented 1.09% of GDP, but the surplus was the lowest since 2004. Differences between Commission and Ministry data on funds allocated from the EU budget occur because the Ministry data does not include funds allocated to recipients in Slovenia with whom the European Commission concludes direct agreements. Advance payments from Structural Funds and funds for rural development, which are already EU budget expenditure, become revenue in the Slovenian budget only when the requirements are fulfilled.<sup>19</sup>

<sup>16</sup> This also meant higher budget revenue.

<sup>17</sup> In 2007, programme documents were adopted and a new institutional structure formed for the implementation of programmes in the new programme period 2007–2013; actual absorption is expected to increase in 2008.

<sup>18</sup> In December 2005, a new financial perspective was adopted for 2007–2013. Based on the new financial perspective, in a period of seven years Slovenia is entitled to EUR 5,128m (current prices), and up to EUR 712.7m of this amount in 2008. Slovenia may utilise funds from the previous financial perspective allocated in 2006 until the end of this year.

<sup>19</sup> The funds are shown among state budget revenues only when the costs related to a certain project actually occur, and are at the same time shown as expenditure in the state budget.

Table 5: Net position of the Republic of Slovenia with respect to the EU budget 2004–2007

	in EUR m			
	2004	2005	2006	2007
Total funds received from the EU budget	282.0	366.2	406.1	390.1
Total payments to the EU budget	170.4	274.7	279.1	359.4
Net position – accounting definition*	111.6	91.5	126.9	30.7
Net position** (operating budgetary balance)	109.7	101.5	142.7	88.5

Source: EU Budget 2007 Financial Report

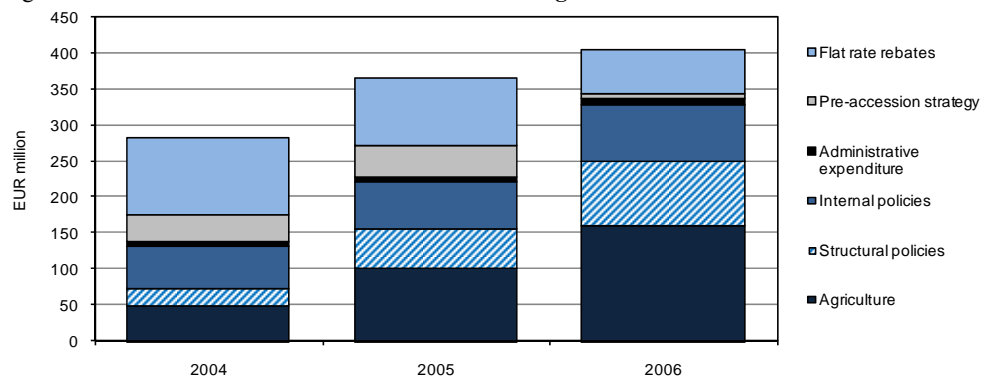
Notes:

\* Net position based on accounting definition is calculated as the difference between total receipts and total payments.

\*\* Net position is calculated as the difference between allocated and contributed funds, excluding administrative expenditure, and taking into account adjusted national contributions based on the UK rebate.

*In the period since joining the EU, the structure of financial flows between Slovenia and the EU budget has changed.* Slovenia has obtained the majority of funds on the basis of the Common Agricultural Policy, and the majority of remaining funds for implementing internal policy. In the past two years, the absorption of funds from cohesion funds and for programmes within common agricultural policy greatly increased, while the share of funds from pre-accession strategy declined. That is, within the framework of the pre-accession strategy, Slovenia received funds only for the PHARE and ISPA programmes, while the SAPARD programme was completed in 2005, and the measures of this programme were financed as part of the Common Agricultural Policy. We estimate that structural changes also occurred last year, because Slovenia was entitled to flat rate rebates on the basis of the Accession Treaty only until the end of 2006.

Figure 9: Structure of funds received from the EU budget 2004–2006



Source: EU Budget 2006 Financial Report

*The supplementary budget for 2008 anticipates that Slovenia will be a net recipient of EU budget funds at the end of year.* In the first half of this year, Slovenia was a net contributor of funds to the EU budget. With regard to trends in recent years, we may expect that higher absorption of funds from the EU budget will occur only in the second half of the year. Under the assumption that this year some of the funds planned to be utilised last year will be absorbed in addition to the funds planned for this year, Slovenia's net position in the EU budget will again be positive in 2008.



## 2.4. General government debt and debt guaranteed by the Republic of Slovenia

*At the end of 2007, the share of general government consolidated debt reached its lowest level thus far, with 24.1% of GDP.* Compared to 2006, the debt ratio was lower by 3.1 p.p., which was the most significant drop since 2000, when the share of the debt started to decrease.<sup>20</sup> Managing government debt, which comprises replacing expensive forms of borrowing with cheaper alternatives, and debt redemption, had a positive impact on the process.<sup>21</sup> The further reduction of the effective interest rate resulted in lower budgetary funds for payments of interest on accumulated debt and therefore had an impact on the reduction of the budget deficit. Debt also decreased more than expected last year because of a lower government deficit than expected.

*Important debt reductions resulted from early debt repayments.* Since the end of the 1990s, a strategy of debt redemption has been implemented in order to reduce the costs of debt service in the long-term and achieve higher liquidity. After joining the EMU, this process could intensify due to entering a more developed financial market. In 2007, debt redemption amounted to EUR 1bn, which was the highest amount since 2004. Government debt of EUR 76m was prepaid by using some of the privatisation fees from the sale of the second largest Slovenian bank Nova Kreditna Banka Maribor – NKBM and the Slovenian steel company Slovenska industrija jekla – SIJ.<sup>22</sup>

*While replacing expensive borrowing with cheaper alternatives, the favourable debt structure also contributed to reducing the burden of debt service.* Since joining the EMU, the majority of debt is denominated in EUR. In recent years, borrowing to a large extent became long-term, with mainly fixed interest rates. In 2007, debt with a variable interest rate represented only around 2% of total debt.

*A simulation shows that the debt financing burden would increase with a rise in interest rates and slower economic growth.* With regard to term, currency and interest structure, debt is sensitive to changes in ECB interest rate levels, especially in the long-term, while it is quite stable in the short- and medium-term. A simulation of debt sensitivity to changes in interest rates<sup>23</sup> shows that if ECB interest rates rise by 100 basis points in 2008, the costs of debt repayment would increase by 0.04% of GDP in 2009. A simulation of debt sensitivity to changes in economic growth indicates that, if GDP growth is slower by 1 p.p. per year in 2008 and 2009, the share of general government debt would increase by 0.4% of GDP in 2009.

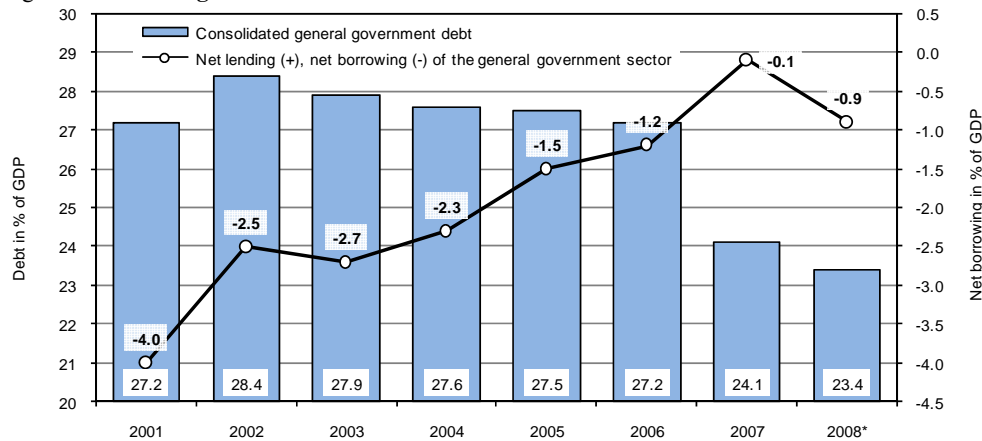
<sup>20</sup> With the revision of total general government consolidated debt for the period 2001–2006, the outstanding debt as a share of GDP at the end of 2006 accounted for 27.2% of GDP, about 0.5 p.p. less than before the revision. Last year, the Ministry of Finance published revised data following total consolidation within and between subsectors. The revision was made for the whole period from 2001 on. At the beginning of this year, another revision was made for the years 2005 and 2006, which resulted in a slight increase of the debt for these two years. However, the revised data resulted in a decrease of the general government debt outstanding for the entire revised period. Local government debt was revised upwards after the inclusion of data on leasing for the period up to 2005. The first revision was published in the Report on government debt and deficit, submitted to the European Commission in October 2007 and the second revision in the Report submitted in April 2008.

<sup>21</sup> State budget debt in the period 2001–2006 decreased relatively faster than general government debt, and by the end of 2007 it fell to 22% of GDP.

<sup>22</sup> The supplementary budget for 2008 anticipates that also this year a part of the inflows from the privatisation of NKBM and SIJ will be used to reduce government debt.

<sup>23</sup> Stability Programme, December 2007.

Figure 10: General government debt and deficit as a share of GDP



Source: Ministry of Finance, 2008  
Note: \*Forecast for 2008 from the Debt and Deficit Report, April 2008.

*The debt of the central level of the government represents the largest share of debt.* In the past three years, this share has been at around 97% of total unconsolidated debt, or 99% of total consolidated debt. Borrowing at local government level is restricted by two fiscal rules: in a certain year, it may not exceed 20% of the revenue of the previous year, and the costs of debt servicing may not be higher than 5% of realised revenue in the previous year.<sup>24</sup> The debt of the social security funds (the pension fund - ZPIZ and the health fund - ZZZS), which was transferred in its entirety to the state budget in 2005, at this moment represents only the borrowing balance of ZZZS in the form of leasing.

*In 2007, the share of guarantees increased again, and at the same time the share of called guarantees decreased.* The share of called guarantees, which until 2000 stayed at around 2% of total guarantees, has decreased<sup>25</sup> considerably in recent years and amounted only to 0.05% of total guarantees in 2007. In terms of share of GDP, this is only 0.1%. With regard to the structure of guarantees, it is not very likely that larger guarantees will be called in the coming years. The largest share of guarantees in 2007 went to companies in the field of transport and communications (66.3%) and in financial intermediation (28.5%).

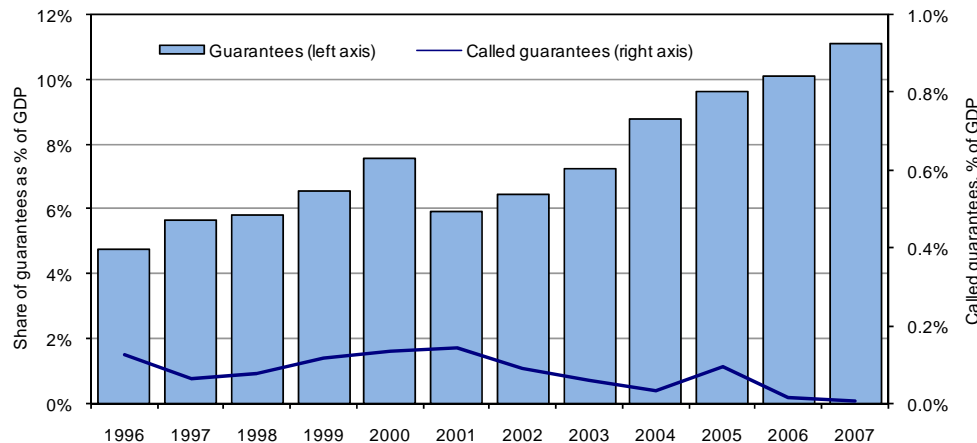
*In April 2008, two guarantees were issued/signed for a total of EUR 675m.* The first guarantee was issued on the basis of the Act Regulating the Guarantee of the Republic of Slovenia for the obligations of the highway company DARS from 2005, in the amount of EUR 145m. The second guarantee, for EUR 530m, was issued to SID Banka on the basis of the Act Governing the Insurance and Financing of International Commercial Transactions from 2004. In April this year, the guarantee to the Ecological Fund (Ekološki sklad RS) also became valid. A contract for liabilities in the amount of EUR 30m was signed in September last

<sup>24</sup> The servicing of debt may increase by an additional 3% of last year's revenue to finance investment projects in education, dwellings, water supply and waste disposal and for projects co-financed by EU funds. The restricted amount of borrowing includes leasing, trade credits and any other contractual engagement which would represent the actual indebtedness of the local budget (Financing of Municipalities Act, Official Gazette, No 123/2006).

<sup>25</sup> Except in 2005, when two large guarantees were called, but they were the first and only ones thus far for these two companies.

year, but it entered into force on the date of EIB confirmation on receipt of ratification.

Figure 11: Debt guaranteed by the Republic of Slovenia and guarantees called



Source: Ministry of Finance, 2008  
Note: Data on guarantees is based on the GFS methodology.

## 2.5. Long-term sustainability of public finance

*Considering current demographic trends, the most important challenge for fiscal policy in the next decades will be to maintain the sustainability of public finance.* Population projections by Eurostat<sup>26</sup> show that by 2050 the share of the population over 65 years of age will rise quickly in Slovenia, and the share of the population from 15 to 64 years of age capable of work will fall. Based on the baseline scenario of population projections, the old-age dependency ratio (the size of the ageing population relative to the number of people of working age) is forecast to increase from 21.7% in 2005 to 55.6% in 2050.

*Due to the extremely high growth of expenditure linked to ageing, Slovenia is among the more exposed EU countries in terms of ensuring the long-term sustainability of public finance.* In its last assessment of long-term sustainability, the European Commission placed Slovenia in the group of countries most exposed to public finance risk caused by population ageing, along with Greece, the Czech Republic, Hungary and Cyprus. The estimated growth in expenditure linked to ageing by 2050 is between 9.9% BDP and 10.4% BDP (see Figure 6), whereby none of the assessments considers reducing the initial balance of actual obligations in past years. The decline occurred because of the simultaneous effect of two factors after the implementation of tax reform: growth in wages lagged behind growth in productivity, and at the same time the tax reform caused a delay in the implicit taxation of pensions.<sup>27</sup> Under the circumstances of expected demographic trends and under the assumption of an unchanged economic

<sup>26</sup> In 2008, Eurostat prepared the EUROPOP2008 demographic projection for the analysis of the fiscal effects of ageing. Changes in the age structure of the population were recorded compared to the previous EUROPOP2004.

<sup>27</sup> The impact of the performed valorisation was therefore lower than that calculated in projections of expenditure.

environment and policies, public debt would start to increase after 2015, concurrent with an increase in general government expenditure linked to population ageing, and would become unsustainable by 2050.

Table 6: Projections of fiscal indicators for the long-term sustainability of public finance

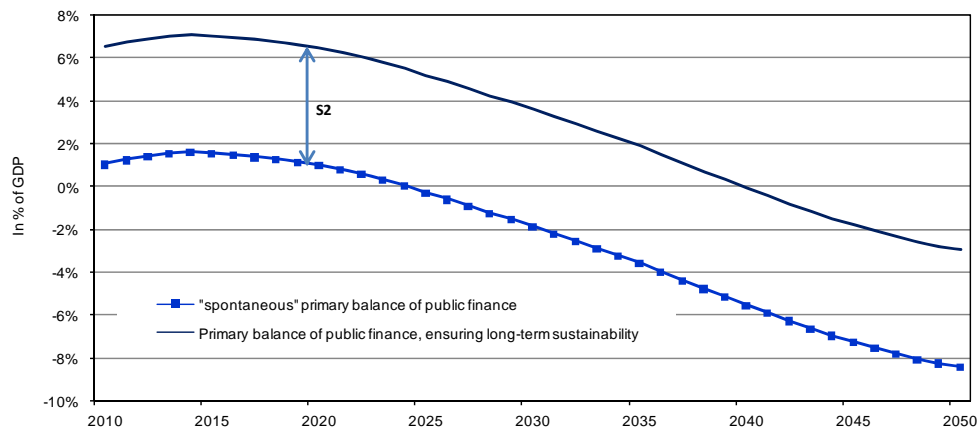
SLOVENIA	Changes in expenditure linked to ageing		Sustainability gap		Debt dynamics				Required primary balance
	Change from 2010 to		S1	S2	2007	2010	2030	2050	
	2030	2050							
European Commission	4.6%	9.9%	3.0%	6.5%	25.6%	23.0%	45.0%	227.0%	7.3%
Stability Programme – update 2007	5.0%	10.4%	1.6%	5.5%	25.3%	21.1%	16.0%	164.1%	6.6%

Source: Stability Programme 2007, European Commission: Slovenia – Macro Fiscal Assessment, An Analysis of the November 2007 Update of the Stability Programme, 2008.

Note: Primary balance, increased by the value of indicator S1, ensures achieving the reference debt margin (60% of GDP) in 2050, if the course of policies does not change during this time. Primary balance, increased by the value of indicator S2, ensures fulfillment of an inter-temporal budget constraint over an unlimited time horizon, if during this time policies remain unchanged.

*Indicators S1 and S2, which measure the budget adjustment required to ensure the sustainability of public finance, confirm that the pressure on public finances is considerable.* Based on recent calculations,<sup>28</sup> the value of parameter S1 is 1.6% of GDP, which means that the primary balance should be higher by 1.6 p.p. per year until 2050 in order not to exceed the reference debt margin (60% of GDP) in 2050. The value of parameter S2 is 5.5% GDP, which means that the primary balance in the coming years should be 5.5 p.p. higher per year in order to remain within the intertemporal budget constraint (see Figure 12).

Figure 12: Projected fiscal balance with regard to the indicator of long-term sustainability



Source: Ministry of Finance, 2008

<sup>28</sup> Stability Programme 2007.

*Systemic adjustments are necessary to preserve the long-term sustainability of public finance.* Increased obligations to finance pensions require the restructuring of general government expenditure and adjustments in the pension system, including the mechanism of pension valorisation and encouraging additional voluntary pension schemes. Immediate changes in the sphere of regulating pensions would reduce the costs of the required adjustment. An additional argument for quick action is that the burden of adjustment would be distributed among generations. Given the expected demographic changes, not only expenditure on pensions will increase, but also expenditure in other fields of public financing, especially healthcare and long-term care. The implementation of economic policy measures in the sphere of employment and productivity, in terms of increasing work activity in old age, may contribute to reducing the pressure of demographic changes on public finance.

### 3. Fiscal policy and long-term growth

*With the efforts to increase economic growth potential in the EU, the development role of fiscal policy has strengthened alongside its stabilisation role.* The strategic framework for the coordinated implementation of economic policies in the EU is aimed at higher economic growth and more jobs. Under the pressures of globalisation and unfavourable demographic trends, fiscal policy also assumed more of a development role. If economic growth is a prerequisite for better social inclusion and more jobs, then fiscal policy objectives are important preconditions for growth: greater adjustment capacity to external shocks, the stabilisation role and the long-term sustainability of public finance. Monitoring the quality of public finance is not coordinated among the EU Member States in terms of methodology, so the European Commission has started developing a common framework for measurement and assessment, which after its formal adoption Members should adopt and implement to gain a comprehensive analysis of public finances and their quality.

#### 3.1. Methodological framework for measuring the quality of public finance

*The European Commission is placing the quality of public finance in a multi-dimensional framework.* The conceptual framework includes elements of fiscal policy and activities in other spheres linked to them which support long-term economic growth. At the centre of the six dimensions remain the required adjustments imposed upon fiscal policy by the Treaty of Lisbon and the Stability and Growth Pact.

*The first dimension is defined by the size of general government.* This dimension is not necessarily of key importance for the development impact of fiscal policy, as the long-term connection between the scope of government and economic growth is uncertain. Despite a relatively large scope, countries may have a successful fiscal policy by using an efficient tax system, and at the same time ensure the efficient use of public funds.

*The second dimension is represented by the size and variability of the government deficit.* This is directly reflected by the provisions of the Stability and Growth Pact which are aimed at supporting economic growth by smoothing the business cycle and ensuring the long-term sustainability of public finance.

*The third dimension comprises the composition and efficiency of government expenditure.* In conditions of permanent pressure from increasing obligations (e.g. ageing of the population), in addition to an appropriate composition of government expenditure, it is of key importance to ensure the efficient use of public funds. Surveys on efficiency of public expenditure for education and health, which are most common due to data availability, indicate room for improvement.<sup>29</sup> The

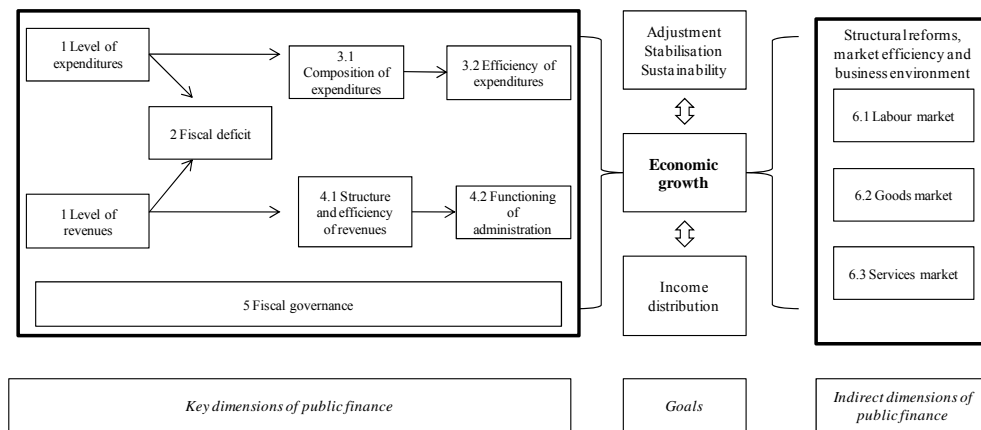
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<sup>29</sup> International surveys performed by the International Monetary Fund, based on the DEA (Data Envelope Analysis) methodology, places Slovenia in the group of countries with the lowest efficiency of public spending in health care and education. Efficiency coefficients show that the same result could be achieved with approximately two thirds of the resources, assuming that the resources were used as efficiently as in the most efficient country in the studied sample (IMF, 2006).

contribution of the dimension of the size and structure of government expenditure to economic growth is greater in those countries where the implementation of programmes and measures is supported by fiscal rules on the expenditure side, a results-oriented budget and a firmly established medium-term policy.

*The fourth dimension is determined by the structure and efficiency of government revenue.* The structure of government revenue reflects the development capacity of the tax system to directly influence the adjustment capacity of the economy. Because of the impact on job supply and the accumulation of capital, a relatively higher share of indirect taxes in the total structure of revenues may have a faster and greater impact on increasing the potential for economic growth; a simple, transparent tax system which ensures more complete coverage of tax collection with lower administrative costs contributes especially to higher efficiency from government revenue.

Figure 13: Six-dimensional framework of public finance quality for ensuring economic growth



Source: European Commission, ECFIN: The Quality of Public Finances: a Roadmap for Deriving a Conceptual Framework and Set of Indicators (Note for the EPC Working Group on QPF), Brussels, 1 February 2008

*The fifth dimension is fiscal governance, which cuts through all previous dimensions of public finance quality.* A modern institutional framework with independent fiscal institutions,<sup>30</sup> clearly defined medium-term fiscal objectives and binding fiscal rules enables greater discipline and thereby reduces fluctuations and contributes to the long-term sustainability of public finance.

*The sixth dimension comprises all activities which are outside of but tightly connected to public finance.* Adjusting the regulatory and legislative framework as part of structural reforms is essential for good performance in labour, products and services markets, which have an important impact on the better responsiveness of the economy to shocks and long-term trends. Fiscal policy has a

<sup>30</sup> Regimes which, as part of the budget process, delegate responsibility for the planning stage (partly) to institution/s which are organisationally not subordinate to the bodies responsible for the implementation stage – for example, the procedure for preparing the strategic macro-fiscal framework – may be, on the basis of realistic assumptions, more successful in realising the plans (see Report on Quality of Public Finances Issue, 2008).

key role through its impact on the mobility of production factors, labour market participation, wage policy and the business environment.

*A multi-dimensional framework of public finance quality is a methodological and statistical basis for comparison between EU Member States.* As a lack of data and inappropriate data sources hamper analytical work, records and indicators are currently being thoroughly harmonised,<sup>31</sup> especially in measuring the efficiency of government expenditure, which has an important impact on accelerating economic growth. A comprehensive analysis should include data on inputs, outputs and outcomes, but the complete set of indicators is not yet completely developed. For example, in some areas output indicators are available, but there are no coordinated indicators to measure outcome.<sup>32</sup> Uniformity of procedures to measure efficiency is necessary to improve comparability between countries.

*A comprehensive survey of public finance quality for Slovenia has not yet been performed.* Separate dimensions are partly addressed in our regular presentation of fiscal developments and policy in the present publication (see especially Sections 2.1., 2.2. and 2.5.), and the analysis is supplemented this time with an attempt to address the efficiency and effectiveness of government revenue and expenditure. Revenue efficiency is analysed in the light of the effects of the latest tax reform; the efficiency of government expenditure is reviewed for two types of expenditure, with regard to the accessibility of data and information and its actuality: state aid and expenditure for social protection.

### 3.2. Efficiency of government revenue

*An efficiency analysis of government revenue assesses the impact of the tax system on the allocation of production factors and, consequently, the stimulation of stable and long-term growth.* The tax system determines economic conditions and is an important factor in economic decisions which further influence the allocation of production factors. Key dimensions in the assessment of government revenue efficiency are height and the ratio between tax burden of labour and capital, because of their influence on the allocation of factors and competitiveness of the economy, and the prospect of accelerated economic growth and employment. The assessment of tax system efficiency below is limited to the consequences of the latest tax reform.

*Tax changes in 2007 reduced the tax burden.* The total burden of taxes and contributions in Slovenia in 2006,<sup>33</sup> measured as a share of GDP, was 39.3%, slightly below the EU average of 41.2%, but it deviated from other countries by having an above-average tax burden on labour and consumption and a below-average tax burden on capital. A tax reform was introduced in 2007 aiming at increasing the competitiveness of the economy and creating a stimulating tax

<sup>31</sup> As part of designing a unified methodological framework for analysing the quality of public finance, the European Commission has started collecting the indicators used in individual Member States. In the next step, the Commission will develop composite indicators for monitoring the condition and trends in all dimensions.

<sup>32</sup> For education, it is quite simple to measure output (e.g. by assessments within the Programme for International Student Assessment (PISA)), but more difficult to measure outcomes (e.g. employability). An example of an incomplete indicator is life expectancy, which does not include quality of life.

<sup>33</sup> The last year for which comparable data for the EU are available.



environment: personal income tax and corporate income tax were adjusted, civil taxes and real estate sale tax were regulated anew and the Value Added Tax Act was amended. The regulation of excise duties changed as well: the reduction of excise duties on petroleum products buffered the impact of rising oil prices on domestic inflation, and increasing excise duties on cigarettes finally adjusted their level to the European directive. Excise duties on electricity and a new tonnage tax were also introduced.

***The reform of corporate income tax reduced the general tax rate, at the same time tightening tax relief.*** In addition to amended regulations to determine the tax base, a gradual reduction in the general tax rate was adopted (from 25% in 2006 to 23% in 2007, and then decreasing by one percentage point each year, until reaching 20% in 2010), and the 20-percent relief on investment in equipment and intangible long-term assets was abolished.<sup>34</sup>

***The increase in the effective rate of corporate income tax shows an increase of this tax burden in 2007.*** Based on the Tax Administration Office's preliminary assessment<sup>35</sup> for 2007, the effective corporate income tax rate increased by 0.4% p.p. with regard to the previous year, totalling 19.2%. In conditions of good business results, this is, at a 2 p.p. lower normative tax rate, mainly a consequence of abolishing tax relief on investment. Due to the higher effective tax rate, the share of the corporate income tax in GDP increased to 3.3% of GDP (see Section 2.1.).

***With the modification of burdens for taxable persons, the tax reform resulted in reduced budget revenue from this tax.*** The new Personal Income Tax Act implemented, with the existing definition of the tax base, a three-level tax scale (16%, 27% and 41%)<sup>36</sup> and simplified the tax relief system. Relief for various expenditures (up to 2% of the tax base) and tax relief for the purchase of a dwelling (up to 4% of the tax base) were abolished, while slightly higher general relief for all taxable persons was introduced; all relief linked to the status or activity of a taxable person was retained.<sup>37</sup> Last year, the average annual personal income tax burden on wages fell from 14.1% to 12.95% compared to the year before. This contributed considerably to the almost 3% decline in real terms in revenue from personal income tax. Consequently, its share declined to 5.4% of GDP compared to 2006 (see Section 2.1.).

***As a result of the amended tax scale, the majority of taxable persons were disburdened, mostly in the lowest and highest income brackets.*** The highest reduction (20.1%) occurred in the lowest income bracket, with the annual tax base at EUR 13,600. At the limit where the tax rate increases, the reduced burden is less obvious. The smallest difference between the new and old systems (only 2.5%) is for the bracket at the EUR 44,000 tax base. Above this amount, the effect of disburdening strengthens again with the growing tax base. The reduction is

<sup>34</sup> The law permits only 20-percent relief on investment in internal research and development activities, and for the purchase of R&D services, relief for the employment of disabled persons, and for performing practical work in professional education, relief for voluntary supplementary pension insurance and for donations, and additional relief for less developed areas.

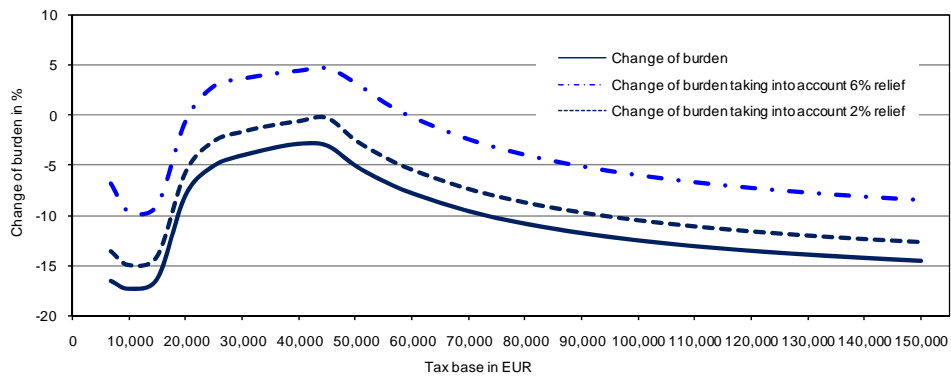
<sup>35</sup> The assessment already includes anticipated payments of final tax assessments in the current year.

<sup>36</sup> The new tax scale has two fewer classes: the highest tax rate was abolished (50%); two medium bands (33%, 37%) were merged into one with a lower rate than before (27%), while the low rate remained unchanged (16%).

<sup>37</sup> Relief for dependent family members has not changed much; disabled relief and senior relief for persons aged over 65 were retained; also relief for self-employed professionals in culture, journalists, student work and voluntary supplementary pension insurance remain valid.

actually lower because the new tax system abolished special relief for various expenses (2% of the tax base) and for the purchase of a dwelling (4% of the tax base). For a tax base between EUR 21,000 and EUR 60,000, taxable persons may actually be liable to pay more, on the assumption that taxable persons prior to the modification of the system exercised the right to one or both forms of relief (see Figure 14).

Figure 14: Impact of the modified tax scale on burdening of the tax base

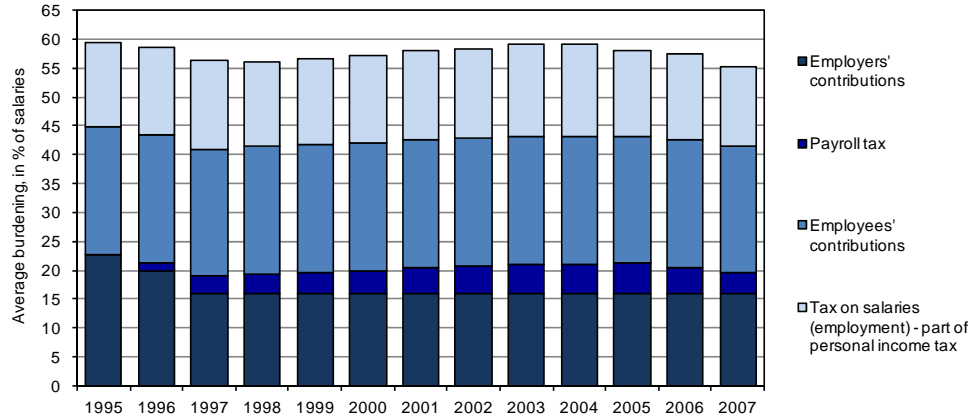


Source: calculations by IMAD

Note: The tax base is the base on which personal income tax as per the valid tax scale is calculated. Tax relief represents a share of the tax base. The calculation takes into account the possibility of exercising special relief for various expenses in the amount of 2%, as well as an additional 4% for the purchase of a residence (up to 6% of the base).

***In 2007, disburdening of salaries continued by reducing the payroll tax rate in the process of its gradual abolishment.*** Payroll tax was introduced in the second half of 1996 as an industrial policy measure to provide a source for financing the deficit which had occurred in the pension fund as a result of a reduction in social security contributions on the lowest wages. The rate of the employer's contribution to pension and disability insurance was reduced by 4 p.p. (from 12.85% to 8.85% of salaries), which should especially help labour-intensive industries such as timber, textiles, leather and construction. The lower limit of wages exempt from payroll tax was specified; otherwise, tax was paid on a progressive scale. The average payroll tax burden has grown over the years, from 3% of wages at the introduction of the tax to 5.1% in 2005, when the decision to abolish it by 2009 was taken. The gradual reduction in the payroll tax rate for the respective tax brackets (from 3.8%, 7.8% and 14.8% in 2005 to 3.0%, 6.3% and 11.8% in 2006, and then 2.3%, 4.7% and 8.9% in 2007) reduced the average burden on gross wages from this tax. In 2007, it was 0.85 p.p. lower than the year before at 3.4%, which resulted in an almost 16% decrease in real terms in the revenue from this tax, and its share in GDP declined to 1.2% (see Section 2.1.).

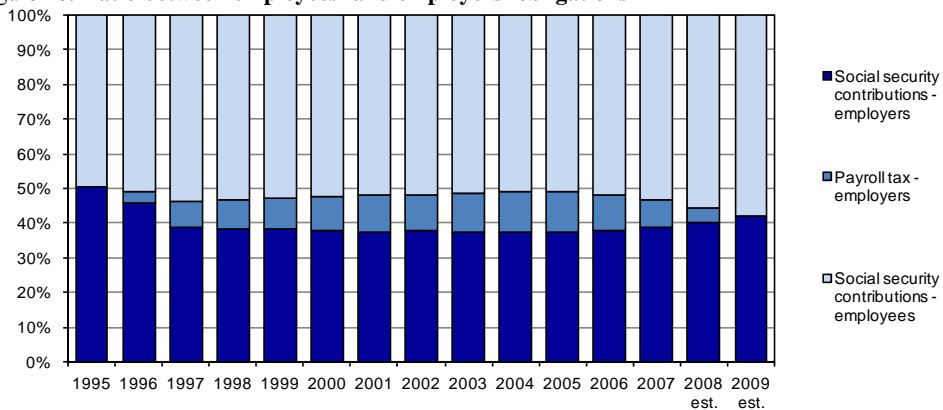
Figure 15: Average burdening of labour with taxes and contributions in % of wages



Source: PPA, Report on allocated general government revenues and cover (B-2), calculations by IMAD

*The gradual abolition of the payroll tax reduces the tax burden on wages and changes the ratio of payments between employees and employers.* Due to the gradual abolition of the payroll tax and the amended tax legislation, with unchanged rates of contributions for social security (38.2% of wages), the total burden of contributions and taxes on wages has been progressively declining in recent years. From 58.1% of wages in 2005, it fell to 57.4% in 2006 and to 55.2% in 2007 (see Figure 15). The abolition of the payroll tax is changing the ratio between contributions of employees and contributions of employers to cover obligations for social security. In 2007, the ratio between employees' payments and contributions and taxes paid by employers was 53:47. It is estimated that the abolition of the tax in 2009 will push up the share of payments of employees to 58:42 (see Figure 16).

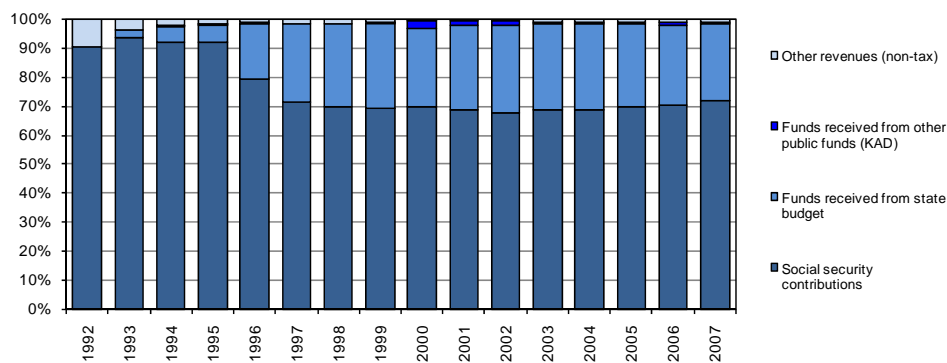
Figure 16: Ratio between employees' and employers' obligations



Source: PPA, Report on allocated general government revenues and cover (B-2), calculations and estimates by IMAD

*The gradual abolition of the payroll tax results in a reduction of budgetary resources.* After the reduction in contributions for pension and disability insurance, a transfer from the state budget ensured slightly above 28% of the annual revenues of the Pension and Disability Insurance Fund (ZPIZ). The transfer was highest in 2002, when it reached a 4.1% share of GDP; afterwards, it slowly fell, and in 2007, when in conditions of higher employment and higher inflation the contributions for social security were above expectations, it amounted to 3.2% of GDP.<sup>38</sup> The role of the payroll tax, which was formally an integral resource of the state budget, was to cover obligations from the ZPIZ social insurance. Between 2000 and 2005 its share was 41–48% of the total annual transfer from the state budget to ZPIZ. The gradual abolition of the tax is reducing the transfer coverage from this resource; in 2007 it represented only 37%, and when it is abolished in 2009, the financing of the transfer to the pension fund will put more pressure on other budget resources.

Figure 17: Revenue structure of the Pension and Disability Insurance Fund (ZPIZ)



Source: MF, Bulletin of Public Finance, calculations by IMAD

*As tax resources decline and obligations grow, a restructuring of the state budget will be required both on the revenue and on the expenditure side.* Transfer to the pension fund represents around 14% of total budget expenditure. ZPIZ expenditure is expected to grow because of population ageing, which will result in a relative increase in transfers to the pension fund in the coming years. Restructuring of budget expenditure or the introduction of new resources will be required.

*The reform of certain income taxes performed last year had a positive impact on government revenues.* Citizens' taxes were regulated anew in separate legal acts. Pursuant to the new *Inheritance and Gift Taxation Act*, regarding immovable and movable property, and also other real property and personal property rights, the number of taxable persons increased. According to the Act, the first order of succession is still exempt from tax, while the tax rates for the next orders of succession are slightly higher. The newly regulated tax base for real estate is

<sup>38</sup> Transfer to the pension fund (ZPIZ) has two purposes: 1) payment of government obligations which are not part of social insurance – ZPIZ has the role of the government's agent for payments, and 2) covering some ZPIZ obligations from social insurance which are not covered with contributions for pension and disability insurance. In 2007, EUR 384m were transferred from the state budget to cover the difference between resources and obligations, which represented around 10% of obligations from pension and disability insurance.

established at 80% of generalised market value on the basis of a regulation on comprehensive revaluation. The *Act on the Taxation of Water Vessels* expands the base of taxable persons,<sup>39</sup> including non-residents if they are registered in the Slovenian shipping register, whereby vessels used for performing registered gainful activity are exempt from taxation. Also, the *Real Estate Sales Tax Act* was amended and specifies in more detail and expands the scope of taxation, whereby the tax base is linked to the generalised value of real estate established in compliance with the *Real Property Mass-Appraisal Act*, and the tax rate remains at 2%. The Act specifies exemptions from tax, while up to now only legal practice was considered. The aforementioned reforms of income taxes had a positive financial impact; in 2007 revenues from tax on real estate sales increased in real terms by around 32%.

### 3.3. Efficiency of government expenditure

*A multi-annual programme approach to planning the use of budgetary funds was introduced in order to improve the efficiency of government spending.* Several years ago, Slovenia started introducing modern budgetary procedures and a results-oriented budget. This was aimed at enabling the monitoring of the efficient use of funds, and by ensuring higher flexibility of government expenditures<sup>40</sup> while also improving their composition. A centralised system of public procurement was introduced which would ensure better control over the use of budgetary funds. The Private-Public Partnership Act was passed last year to stimulate investment projects.

*A system to measure the efficiency of government expenditure is being developed.* The process of selecting useful and reliable indicators which will adequately monitor the achievement of objectives<sup>41</sup> is being hindered by the fact that internationally comparable criteria to assess efficiency are not yet agreed, and in some fields, comparable databases are not available. The statistics on government expenditure based on the classification of functions of government, which only at the second level (COFOG II)<sup>42</sup> enables efficiency assessment, should be completely set up next year. Unified records of development policies per individual programme, project and measure are being prepared,<sup>43</sup> which will enable the assessment of the quality of public finance at programme level. Efficiency indicators for government development policies will probably be available this autumn, and efficiency indicators for development programmes, which will measure quality with regard to *input, output and outcome*, at the beginning of 2009.

*Based on the existing methodological framework, the first assessments of the efficiency of government expenditure and other instruments of fiscal policy were performed.* With regard to methodology and conceptual limitations in

<sup>39</sup> The tax includes vessels 5 m in length (previously, 8 m), whereby the amount of tax is determined with regard to the length and power of the vessel.

<sup>40</sup> Slovenia, with its 72% of fixed expenditure (social transfers, interest, wages and subsidies), is above the average of the new EU Member States, which amounts to 68% (IMF, 2006).

<sup>41</sup> Indicators to measure long-term objectives are specified only for 31% of state budget expenditures, of which half do not have a target value. 61% of state budget expenditures have indicators defined to measure annual objectives (Derenčin, 2006).

<sup>42</sup> Eurostat implemented statistical methodology at the level COFOG II to be used for monitoring government expenditure, where, despite constant progress, considerable limitations in availability of data for all Member States still exist.

<sup>43</sup> Decree on development planning.

monitoring individual spheres of government expenditure, especially in the longer term, we present only the results of the most recent efficiency assessments for two groups of expenditure: social expenditures, which were the central topic of economic policy discussions within the Slovenian Presidency of the EU, and state aid, the efficiency of which was measured in the light of its influence on competitiveness this year for the first time.

### **3.3.1. Efficiency of social expenditure**

*The priority of most EU Member States is to increase the efficiency and effectiveness of social expenditure.* Social expenditure<sup>44</sup> is one of the major items within total government expenditure, both in Slovenia and the EU Member States; in the EU-25 it amounts to an average of as much as 54% of government expenditure, or 27.2% of GDP. The increased efficiency and effectiveness of this expenditure is one of those priorities which are common to most Member States. Because the system of social expenditure is, in addition to the tax system and relief, also part of the system of social redistribution which countries use to alleviate poverty and reduce income inequality, monitoring the trends of this expenditure at the same time represents an assessment of the efficiency of social policy of a certain country. Increased efficiency and effectiveness of social expenditure is therefore important both in the light of ensuring the efficiency of public spending, as well as in the light of the effectiveness of social policy within the context of implementing the Lisbon Strategy. EU countries, including Slovenia, are making many changes aimed at modernising the system and increasing efficiency (see Section 2.2.4. in the chapter "Challenges of the Labour Market from the Aspect of Flexicurity"). In doing so, they need to comply with the principle that reform in one sphere of social expenditure should not neutralise reform in another sphere. Modifications of the complete system of social expenditure, which comprises the system of social protection and the tax system, including tax relief, should be planned in such a manner that partial reforms in various fields act coherently.<sup>45</sup>

*Indicators and appropriate methodologies to measure the efficiency and effectiveness of social expenditure at EU level are in preparation.* The European Commission uses selected indicators for this purpose: 1) share of social protection expenditure in GDP; 2) at-risk-of-poverty rate before and after social transfers; 3) reducing income inequality (quintile coefficient, Gini coefficient); 4) share of administrative costs in implementing social protection programmes; and 5) marginal effective tax rates.

*The basic indicator of social protection – the share of expenditure for social protection in GDP – shows that Slovenia allocates relatively less funding for social protection than the average in the EU.* The share of social protection expenditure in GDP,<sup>46</sup> which varies considerably between EU Member States, depends on tradition and differences in social models, the demographic situation

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<sup>44</sup> Social protection expenditures as defined by the European Commission on the basis of ESSPROS are as follows: old age and survivors, sickness and disability, children and family, unemployed, housing and social exclusion (Efficiency and effectiveness of social spending, Brussels, Achievements and Challenges, 11 March 2008).

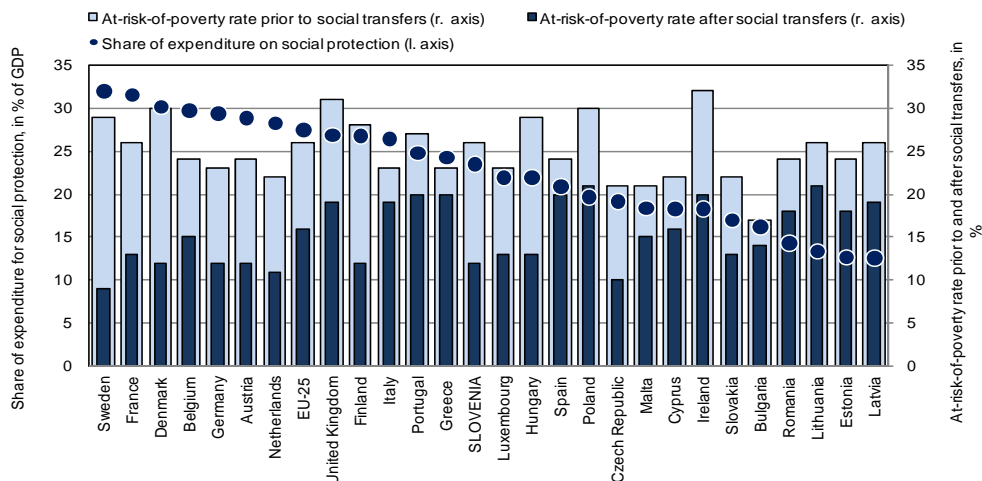
<sup>45</sup> Ecofin conclusions being prepared by the Presidency for the May Ecofin meeting; Annex II, Brussels, 2 April 2008.

<sup>46</sup> European System of Integrated Social Protection Statistics – ESSPROS.

of the country and its level of economic development. In 2005, Slovenia allocated a smaller share of GDP for social protection compared to the EU average: 23.4% compared to 27.2% in the EU-27.

*Without social transfers, the at-risk-of-poverty rate would double in Slovenia, which indicates the extremely high impact of social expenditure on alleviating poverty.* Although the share of social protection expenditure in GDP has slightly declined in recent years, the poverty risk in the same period did not increase, but remained at approximately the same level. Data on the at-risk-of-poverty rate before and after social transfers show the considerable impact of social transfers on alleviating poverty, given that the at-risk-of-poverty rate would double without them (see Table 7).<sup>47</sup> The impact of social transfers on alleviating poverty in Slovenia is greater than the average in EU countries (in Slovenia there has been a reduction from 24% to 12%, in the EU-25 from 26% to 16%).<sup>48</sup> Our assessment is that this is to a large extent the consequence of a selective approach to entitlement to certain social rights, which means that the beneficiaries to a greater extent come from lower income groups (in some EU countries a system of universality is in place for certain social rights).

Figure 18: Share of expenditure on social protection and the at-risk-of-poverty rate in the EU



Source: Development Report 2008

*According to the latest data, Slovenia had the lowest income inequality among EU Member States.* In 2005, Slovenia recorded the lowest income inequality, alongside Denmark, measured by the ratio of quintile classes. In addition, income inequality measured using the Gini coefficient was among the lowest at that time in the EU-25, at 24% (see Table 7).

<sup>47</sup>A number of empirical studies have confirmed the correlation between the extent of social spending and the alleviation of poverty and social exclusion whereby the impact is greater on the reduction of poverty level than on the reduction in at-risk-of-poverty rate. The differences between countries are considerable. Countries with similar levels of social spending achieve different levels of poverty reduction due to distinct socio-economic situations, social policy, etc.

<sup>48</sup>The International Monetary Fund in a survey (IMF, 2006) establishes that, in a sample of 26 countries, Slovenia ranked 19<sup>th</sup> by the efficiency and effectiveness of expenditure on social protection.

**Administrative costs of managing social expenditure were lower than the EU average.** Administrative costs for the implementation and distribution of social protection programmes in 2005 amounted to 2.0% of total expenditure on social protection and were 1.1 p.p. lower than the EU average (see Table 7).

**Labour incentives increased in 2007.** This is confirmed by the reduction of effective marginal tax rates (see Table 7), which are used to measure the combined impact of taxes and social transfers on net income in the transition from unemployment to employment, or from a lower-paid to a better paid job.<sup>49</sup> These rates also indicate individual decisions on employment, or a better paid job. Comparison with the EU shows that Slovenia is lagging behind the EU in these indicators, except in the sphere of tax burdens, where it is close to the EU (see also Section 2.2.4. in the chapter "Challenges of the Labour Market from the Aspect of Flexicurity").

Table 7: Efficiency indicators for social expenditure in Slovenia and the EU, 2004–2007

	Slovenia				EU-25			
	2004	2005	2006	2007	2004 <sup>6</sup>	2005	2006	2007
Share of social protection expenditure in GDP	23.7	23.4	N/A	N/A	27.3	27.2 <sup>1</sup>	N/A	N/A
The at-risk-of-poverty rate before social transfers (pensions excluded from income; income in kind is not considered); in %	N/A	25.8 (IS)	24.2	N/A	26	26	26	N/A
The at-risk-of-poverty rate after social transfers (pensions excluded from income; income in kind is not considered); in %	N/A	12.1 (IS)	11.7	N/A	16	16	16	N/A
Quintile coefficient 80/20	N/A	3.4 (IS)	3.4	N/A	4.8	4.9	4.8	N/A
Gini coefficient (%)	N/A	24 (IS)	24	N/A	30	30	30	N/A
Share of administrative costs in total expenditure on social protection	2.0	2.0	N/A	N/A	3.1	3.1	N/A	N/A
Tax burden on labour costs <sup>2</sup>	43.2	41.6	41.2	40.7	39.8 <sup>1</sup>	39.7 <sup>1</sup>	40.1 <sup>1</sup>	N/A
Unemployment trap <sup>3</sup>	87.7	82.6	82.2	80.7	74.11 <sup>1</sup>	75.04 <sup>1</sup>	75.39 <sup>1</sup>	N/A
Low wages trap for a single person without children <sup>4</sup>	49.1	50.8	51.6	51.0	46.70 <sup>1</sup>	46.71 <sup>1</sup>	47.35 <sup>1</sup>	N/A
Low wages trap for a couple with two children <sup>5</sup>	91.9	76.4	72.6	67.4	58.84 <sup>1</sup>	61.57 <sup>1</sup>	62.19 <sup>1</sup>	N/A

Source: Eurostat EU Portal; Eurostat Data Navigation Three; SORS, Indicators of labour incentives, Slovenia, 2007 – PROVISIONAL DATA; 14 May 2008, Initial disclosure

Notes:

<sup>1</sup> Data for EU-27.

<sup>2</sup> The tax burden on labour costs shows the overall impact of taxes and contributions for social security and social transfers on labour costs, whereby the calculation assumes a single person without children, receiving 67% of the gross wage of an average employed person.

<sup>3</sup> The unemployment trap is the ratio between the net and gross income of a single person without children in transition from unemployment to employment, where it is considered that an unemployed person receives unemployment benefits in the amount of 70% of the gross wage of an employed person, who receives 67% of the gross wage of an average employed person.

<sup>4</sup> The trap of low wages for a single person is the ratio between net and gross income of an employed single person in transition to a better paid job (from 33% of the gross wage of an average employed person to 67% of the gross wage of an average employed person).

<sup>5</sup> The trap of low wages for a four-person household with one employed person and two children shows the ratio between the net and gross income of an employed person in transition to a better job (from 33% of the gross wage of an average employed person to 67% of the gross wage of an average employed person).

<sup>6</sup> The data are not completely comparable to data for Slovenia, because Eurostat has not yet included the new SORS calculations.

N/A – data not available, IS – interrupted series

<sup>49</sup> Effective marginal tax rates measure: tax burden on labour costs, unemployment trap and low wages trap.



### 3.3.2. State Aid Efficiency

*Subsidies and state aid are fiscal instruments used in industrial policy which bolster economic competitiveness and changes in market structure.* Since their influences may also be negative, it is wise to use them only if they were studied accordingly in several respects, mostly from the point of view of their impact on competitiveness,<sup>50</sup> international trade and government expenditure (as well as cost).

*Efficient state aid is aid which is oriented to small and medium-size enterprises, R&D and stimulating employment.* Aid to small and medium-size enterprises has proved to be one of the most efficient purposes of state aid, because it helps increase employment, and boost sales and productivity in enterprises, i.e. aid beneficiaries. The same could be said for efficiency based on return on assets. As distinguished from most other aid purposes, it is efficient in ensuring sustained annual and cumulative improvements in enterprise operations after several years. Analyses have shown that aid is most efficient in the most technology-intensive sectors and in enterprises with a relatively high level of sales per employee, as well as in enterprises employing only a few employees. State aid granted for research and development (R&D) has had a positive, although short-term effect on the volume of available resources to be used for research and development. In contrast to their competition not receiving aid, enterprises that are beneficiaries of aid increased the volume of expenditure in research and development (R&D). On average, larger enterprises (based on total sales) make better use of the allocated aid because the "additionality" effect of state aid can be seen (in case of exclusion from the programme, the aid beneficiary would reduce the total level of expenditure for R&D). There is a greater probability of the substitution effect with small beneficiaries of aid (the aid beneficiary would in the case of exclusion from the programme nonetheless carry out its R&D projects). Multiple consecutive receipts of aid negatively influence increases in the enterprises's own expenditure on R&D. Obviously, enterprises start to behave rationally, making use of public resources from aid programmes instead of using their own assets. Aid used for stimulating employment proved to be a success in increasing employment (in the years following the receipt of aid and also cumulatively until the end of the period of three years), as compared with the year prior to the allocation of aid. The same holds for the efficiency of aid with respect to the allocated funds, where it is required to assess whether the number of additional employees (1.7 to 1.9) per every EUR 4,172 of aid is adequate to justify its volume. The efficiency of aid declines tremendously by each additional amount of aid provided to the same enterprise. On average, aid is more efficient in enterprises with a larger sales volume.

*Aid used for training and achieving regional objectives is not efficient enough.* Allocating *training aid* has successfully influenced the increase of average wages in beneficiary enterprises. It did not increase sharply, since in four years it has amounted to between 8 and 16% of average gross salary from 2003. Less convincing is the evidence on the impact of aid on productivity in beneficiary

<sup>50</sup> The first research in Slovenia (Target Research Programme "Competitiveness of Slovenia 2006–2013", project No V5-0201) was conducted from the point of view of the impact on the economy's competitiveness using the econometric matching method, with which allocated state aid in the period from 1998–2006 was analysed according to individual categories and purposes, recipients and aid intensity, as well as single or multiple allocations to the same beneficiary.

enterprises. Assessments of aid efficiency in other countries are essentially more favourable than in Slovenia. The reasons for this most likely can be traced to the amount of aid per beneficiary (average amounts in Slovenia are quite small), and programmes to which the aid is allocated. *Regional state aid* on average positively impacts sales, employment and added value per employee only in the first two years after the aid is received. According to a somewhat more favourable result in analysing the efficiency of allocated funds, it can be assumed that otherwise this type of aid can be successful in improving efficiency and increasing employment, as well as in boosting sales, but the funds have been distributed inadequately among aid beneficiaries. Here it can also be observed that aid is much more efficient in technology-intensive sectors and that the effect dwindles with the successive granting of aid.

***Aid intended for rescuing and restructuring enterprises is inefficient, as well as aid allocated to special sectors (coal mining, energetics, transport).*** State aid for rescuing and restructuring has proved inefficient in boosting sales, creating new jobs and increasing productivity in beneficiary enterprises. Aid beneficiaries are mostly in sectors which are threatened most because of globalisation pressures, and it is unrealistic to expect to save them from decline. Similarly inefficient is state aid granted according to special sectoral rules. Trends in employment, sales and productivity were no different in enterprises granted aid from similar companies that had not received aid.

***Planning state aid according to specific purposes insufficiently addresses the goal of efficiency.*** Among the *most efficient*, aid for small and medium-size enterprises increased only in 2006 (aid was minimal particularly in the period between 2002–2005). Aid granted for R&D has been decreasing since 2003. In 2006 the positive trend reversed and the share of aid to companies decreased and at the same time the share of aid increased in less efficient research and higher education institutions. Aid stimulating employment has been gradually increasing since 2004 but is still only half the amount of that in 2000–2002. Among *less efficient* examples, aid for training is particularly low, while regional aid, on the other hand, increased significantly in 2005 and 2006 but is still somewhat lower than the average in the EU Member States. Among the *inefficient* examples, aid granted for rescuing and restructuring was abundant in the periods 1998–2001 and 2003–2004 and then stopped in 2005, but it was granted again the following year. Aid granted by special sectoral rules dropped increasingly in the last two years but is still high, mainly due to high levels of aid granted to railways.

***Distributing available state aid to individual beneficiaries is still primarily oriented to "rescuing" bad companies.*** Most aid in manufacturing is directed towards lower and mid-lower technology-intensive business, not only for rescuing and restructuring them but also for other purposes. This indicates that it is not directed to the required structural changes aiming at higher technological intensiveness and thereby strengthening the competitiveness of the Slovenian economy, but rather to solving the problems of existing, less competitive enterprises.

Table 8: State aid distribution by size (in deciles), in 2006

Business (deciles)	Distributed/received amounts of state aid (in deciles)								
	R&D	Environ ment	Energy Saving	R&R	SMEs	Employ ment	Training	Regional objectives	Agricult ure
1	1.00	1.00	1.00		1.00	1.00	1.00	1.00	1.00
0.9	0.38	0.31	0.54		0.16	0.50	0.57	0.24	0.05
0.8	0.25	0.10	0.39		0.04	0.39	0.41	0.11	0.03
0.7	0.18	0.07	0.29		0.03	0.33	0.29	0.05	0.02
0.6	0.12	0.05	0.20		0.02	0.27	0.20	0.03	0.01
0.5	0.08	0.02	0.12		0.01	0.22	0.13	0.02	0.01
0.4	0.05	0.01	0.06		0.01	0.16	0.08	0.01	0.00
0.3	0.03	0.00	0.03		0.00	0.11	0.05	0.01	0.00
0.2	0.01	0.00	0.01		0.00	0.07	0.02	0.00	0.00
0.1	0.00	0.00	0.01		0.00	0.03	0.01	0.00	0.00
In EUR thousands	19,473	2,568	623	2,141	29,270	16,904	1,844	45,897	51,951
Number of companies	245	26	41	6	1,634	4,567	350	115	3,572

Sources of data: Target Research Programme "Competitiveness of Slovenia" 2006–2013, project No V5-0201

Note:

R&D = research and development, R&R = rescuing and restructuring, SMEs = small and medium-size enterprises. For saving and restructuring the distribution can not be shown in deciles because there are too few aid beneficiaries.

The first section of the table displays beneficiaries and amounts of aid in deciles; the second section shows the actual number of beneficiaries in the business register, as well as the amount of aid received. Aid beneficiaries are distributed using tenths of value (that is, in deciles) according to the amount of state aid received. Thus, for example, 90% of beneficiaries of aid granted for R&D (distributed in 0.9 deciles) equivalent to 220 beneficiaries receiving 38% (0.38 deciles) of total aid for this purpose, i.e. EUR 7,400 thousand. The 10% of beneficiaries that received the highest amounts of aid are distributed in the above category (1.00–0.9 deciles). These beneficiaries (25) received 62% (1.00–0.38 deciles) of total aid granted for R&D, i.e. EUR 12,073 thousand.

*State aid in Slovenia poses a potential threat to market competition and is above average from the point of view of expenditure and cost.* The research did not return any explicit assessment for either parameter used for measuring state aid efficiency, but they can be assumed from their concentration (see Table 8).<sup>51</sup> On the one hand, 10% of beneficiaries receive from 43% (training) to 95% (agriculture) of total aid. Some receive this from more than one source. Beneficiaries of large amounts of aid are mainly larger enterprises, which can potentially influence competition in their sector. On the other hand, over half of the beneficiaries receive too little aid to alter their behaviour, which is the fundamental condition of aid efficiency. Thus, the expenditure and costs for the country (costs of taxes to finance state aid, administrative and transaction costs) are greater than the benefits for the beneficiary.

<sup>51</sup> Even greater concentration is shown by subsidies from annual accounts. The top 10% of subsidy recipients are granted from 91–93% of all subsidies annually. A more detailed analysis of market power, measured using the method of the recipient's market share of 40% and CR-4 (top four recipients with a total of 40% of market share) has shown that market competition is threatened in numerous sectors (Murn, 2008: 90–92).

## 4. Key findings and recommendations

With favourable economic conditions in 2007, the fiscal position in most EU Member States improved considerably, the most in recent years. The government deficit reached an all-time low in the Eurozone (0.6% of GDP) as well as across the entire area of the EU (0.9% of GDP). Because of the improved fiscal position and favourable economic trends, total government debt also reached an all-time low. It reached 58.7% of GDP, and was lower than the reference value. In the Eurozone it still remained 6.0 percentage points above margin, despite its decline.

Last year Slovenia featured lower government expenditure, a lower deficit and subsequently lower debt. The deficit of the general government sector has been decreasing compared with gross domestic product in recent years, and in 2007 declined to 0.1% of GDP. Relative to the previous year, the deficit was lower by 1.1 percentage points because general government revenue increased more compared to expenditure, and growth in both categories lagged behind the growth in gross domestic product. Favourable fiscal movements as well as the early repayment of debt and active debt management contributed to lowering consolidated general government debt, which at the end of last year amounted to 24.1% of GDP.

The trend in the cyclically adjusted general government balance shows, besides a favourable macro-economic situation, that fiscal policy measures contributed to fiscal consolidation. Last year, the cyclically adjusted deficit decreased along with the actual deficit, which is in accordance with Stability and Growth Pact provisions and indicates restrictive fiscal policy. Considering the closure of the output gap, this means that fiscal policy last year, for the first time in the observed period, was counter-cyclical and restrictive, which implied a proper response of fiscal policy in respect to its stabilising role in the first year after entering the EMU.

Last year showed favourable movements, but the long-term challenge for fiscal policy to adjust to expected demographic changes still remains. Eurostat's population projections show that the share of the population over 65 will increase rapidly by 2050, while the share of the working age population aged 15 to 64 will decrease. Slovenia is among the more exposed EU countries in ensuring long-term public finance sustainability due to extremely high growth in expenditure related to ageing. If the system parameters and economic policies remain unchanged, in the decades to come they will contribute to increasing deficits and therefore general government debt.

After a substantial decrease in the share of public spending in GDP over the last four years, increasing efficiency and effectiveness is becoming a more and more important aspect of expenditure reform. Several years ago Slovenia started to implement modern budgetary procedures, which should improve the monitoring of efficiency and effectiveness of the use of resources. Sufficient data is not available to run a complete analysis, but assessments were made on the efficiency and effectiveness of social expenditure and state aid. Considering the EU average, Slovenia has a lower at-risk-of-poverty rate and income inequality, despite lower expenditure for social protection. Different effects are achieved with state aid, depending on the purpose of its allocation. Assessments show that the efficiency

objective is not pursued enough in the allocation of aid. A comprehensive analysis of the quality of public finance will be possible following the establishment of a conceptual framework, according to the European Commission's proposal. While methodological and statistical restrictions in monitoring individual fields still exist, it is primordial to improve the systems of measurement.

To ensure good quality of public finance it is important to implement structural reforms. Besides the relative size of fiscal aggregates, the efficiency and effectiveness of government revenues and expenditure is of key importance for the quality of public finance. In the field of government revenue, where in respect of its effects on economic activity efficiency is to a great extent determined by the tax burden on labour and capital, tax reform was adopted in 2007. Due to changes in personal income tax legislation and the gradual abolishment of the payroll tax, the burdening of wages with taxes and contributions declined. The gradual abolishment of the payroll tax contributed to the disburdening of the economy, while the increase in the effective tax rate, following corporate income tax reform, increased the burden.

## Appendix

### Approaches to the calculation of a Medium-term Objective (MTO)

*Approach A* is based on a frontloading adjustment to the medium-term objective (hereinafter: MTO). The MTO is equivalent to the required structural balance (RB) for achieving sustainability, i.e. primary structural balance (PB) added the sustainability indicator S2. In accordance with such an approach, the MTO is calculated using the following formula:

$$\text{MTO} = \text{RB} = \text{S2} + \text{PB} - i \cdot \text{D}$$

where the sustainability indicator of the public financing gap is represented by S2, primary structural balance by PB and interest payments by  $i \cdot \text{D}$ .

*Approach B* is based on the principle of gradual adjustment, where the MTO is determined as the sum of an accordingly selected reference point (RP) and set share of the difference between the required balance and the aforementioned reference point value. The share of the difference represents the volume of adjustment made in the first years of the adjustment period. In accordance with this approach, the MTO is calculated using the following formula:

$$\text{MTO}(\alpha) = \text{RP} + \alpha (\text{RB} - \text{RP}) = (1 - \alpha)\text{RP} + \alpha \text{RB}$$

where the reference point of fiscal balance is represented by RP, RB represents the required balance for achieving and maintaining fiscal sustainability, and  $\alpha$  the share used in measuring the volume of adjustment in the first years. Determining the budgetary reference point follows the existing principle used in calculating the medium-term objective. Using such a method allows sufficient consideration of the different fiscal positions in the Member States. Because of its simplicity and rationality, the following rules are currently used for determining the reference point:

- for countries with a deficit between -1 to -0.5% of GDP, the reference point amounts to -0.5% of GDP
- for countries with a deficit between -0.5% to 0% of GDP, the reference point amounts to 0% of GDP
- for countries which are close to balance or in surplus, the reference point amounts to +0.5% of GDP.

The parameter value used for Slovenia was  $\alpha = 0.5$ , which means that fiscal policy must enable half of the ageing-related expenditure to be covered.

*Approach C* is based on the assumption that the process of public finance adjustments in an individual Member State crucially depends on its specific economic situation. In accordance with this assumption, the formula used in calculating the MTO enables better inclusion of the specific concerns of individual countries:

$$\text{MTO} = \text{RP} + \text{SM}$$

$$\text{MTO} = \text{RP} + \alpha((\text{RB} + \text{LTF}) - \text{RP})$$

where RP represents the reference point, RB the required balance, LTF additional long-term factors, and  $\alpha$  the share used in measuring the volume of adjustment in the first year. Such an analytical framework allows for other sustainability factors to be considered when assessing fiscal position and not only outstanding government debt.

The proposed approach puts greater stress on the existing debt and fiscal position. All three approaches are flawed by disregarding outstanding debt, putting countries with lower levels of outstanding debt such as Slovenia in an unequal position in comparison to countries whose outstanding debt levels are higher. This flaw could be removed by adjustments to the formula. According to one of the informal European Commission's proposals, we could add the expression  $\beta(D_t - 60)$  to one of the above-mentioned rules, where  $D_t$  would represent the share of debt in the current year's GDP, and  $\beta$  a value parameter between 0 and 1 ( $1 > \beta > 0$ ), further representing the share of the difference between outstanding debt and the allowed upper debt margin (60% of GDP). Here the difference depends on the fiscal policies pursued by the various countries. Including a new expression in the formula would mean that countries with a high-level indebtedness should have a higher medium-term objective than envisaged using approaches A, B or C. On the other hand, countries with a low-level of indebtedness may have a lower MTO than any envisaged using the above-mentioned approaches.

In accordance with the above guidelines, the new medium-term objective could be determined using the following formula:

$$\text{MTO} = ((r-g)/g)(0.03-m)$$

where the average effective interest rate of government debt is represented by  $r$ , the average nominal trend economic growth is represented by  $g$ , and the safety margin by  $m$ .

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***Development of the Financial  
Sector and Analysis of Financial  
Flows***



## Summary

The process of Slovenia's accession to the EU, liberalisation of capital movements and joining the EMU increased Slovenia's integration in international financial and monetary flows. This contributed to the faster growth of financial flows in Slovenia in recent years and gradual reduction of the development gap between the Slovenian financial sector and the average of the EU and EMU.<sup>1</sup> Despite this, the gap in this area is still wide and exceeds the difference Slovenia records in terms of economic development (gross domestic product per capita by purchasing power), which in 2007 reached 89% of the EU average and 81% of the EMU average.

The most important segment of the Slovenian financial sector is banking, where somewhat faster progress has been made. Nevertheless, Slovenia records only a third of the EMU average in terms of banks' total assets in comparison with GDP. In the two other segments (insurance, capital market) the relative difference in development is smaller.

The volume of bank loans to non-banking sectors in comparison to GDP in Slovenia is the lowest among the EMU countries, and in 2007 reached two thirds of the EMU average. Within that, the difference in the share of loans to companies and non-monetary financial institutions is relatively lower than the share of credits to households. Borrowing by companies and non-monetary financial institutions has been more intensive in recent years than household borrowing, and contributed up to 80% of the overall net borrowing of domestic non-banking sectors. This is also due to the redirection of companies and non-monetary financial institutions from borrowing on foreign markets to borrowing from domestic banks, in accordance with the process of convergence of interest rates and improvement of borrowing conditions in Slovenia after 2004. Household borrowing is also an important part of banks' lending activity in developed financial systems. However, in this regard Slovenia has the lowest share relative to GDP among all EMU member countries despite households' intensive taking of bank loans in recent years. The lag is relatively higher for housing loans than for consumer loans to households, although the former have been growing more rapidly in recent years.

The significant growth in loans in recent years is not only characteristic of Slovenia, as the lending activity of banks has also increased in developed financial systems in the environment of high economic growth and low interest rates. However, in Slovenia, this growth was relatively higher than the average of the Eurozone countries.

In Slovenia, banks lowered deposit interest rates in the process of convergence of interest rates to the EU level somewhat faster, and for a year and a half they have remained below the EU average, while lending interest rates are above the EMU average. Among lending interest rates, the biggest differences between Slovenia and the EMU occur in interest rates for housing loans, while the differences between interest rates for consumer loans and loans to companies are somewhat smaller.

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<sup>1</sup> After Slovenia's entry into the EMU, the Slovenian financial sector can be compared to the average of the Eurozone, where the difference is somewhat greater than in comparison with the EU average. On the other hand, in terms of development of the financial sector Slovenia is achieving relatively better results than the majority of new EU Member States.

The population adjusts the structure of their savings to changes in interest rates and better savings options on the market. In recent years, the decrease of deposit interest rates has resulted in lower growth of households' savings in banks. With favourable trends on capital markets at home and abroad (up to last August), increased domestic and foreign investing options, and intensive marketing, savings in mutual funds has strengthened significantly in recent years. The volume of assets in mutual funds at the end of last year reached almost a quarter of savings in banks. The importance of pension funds has also increased.

Low rates of growth in bank deposits and high demand for loans have led to increasing external financing of banks, mainly through long-term foreign loans. This also influenced changes in the structure of liabilities of domestic banks, where the share of foreign sources is increasing. After the outbreak of the international financial crisis in August 2007, banks increased the volume of short-term borrowing abroad in aggravated conditions on the inter-bank market. Considering that these sources are still loaned mostly on a long-term basis, this worsens maturity matching of the balance sheet, and consequently increases liquidity risk. Increased borrowing abroad led to the growth of overall gross external debt, which stood at 102.4% of GDP at the end of 2007. Although gross external debt is growing relatively rapidly in comparison with other EMU members, Slovenia is still among the least indebted countries in the Eurozone.

Besides the increased borrowing of primarily domestic banks abroad, Slovenia's accession to the EU and EMU also strengthened Slovenia's integration into other international financial and capital flows. International assets increased, primarily in portfolio and direct investment, commercial loans and bank loans. Liabilities also increased strongly; besides loans, growth was recorded in foreign banks' deposits, foreign commercial loans and portfolio investment and to a lesser extent also in foreign direct investment. Total liabilities grew faster than total assets, and thus the net financial position turned into a deficit. The majority of the deficit is represented by net external debt, which stood at 18.9% of GDP in 2007. The deficit of the net financial position stood at 21.9% of GDP at the end of the year.

The impact of the financial crisis which started in August 2007, considering integration and exposure of financial sectors to external shocks, is reflected to varying degrees in different countries. The overall loss for banks and other financial institutions at the global level stands at over USD 300 bn, while the IMF estimates that the overall loss could exceed USD 900 bn. Considering the scope of the crisis, the consequences will be felt not only in the financial sector, but also in the real sector, although these effects differ from country to country. The direct impact of the financial crisis, which is felt in all countries, is an increase in interest rates on inter-bank markets because of aggravated conditions in these markets and less confidence among banking subjects. Countries, including Slovenia, in which modern financial instruments are relatively less developed than in the US and some EU Member States, are relatively less exposed to other direct effects of the financial crisis. Increased risk related to the consequences of the financial crisis is shown in these countries primarily in the case of closer ties with exposed banks abroad. Here, dependence on foreign financing does not necessarily imply negative effects of the financial crisis, but it does increase the related risks. In Slovenia, the worsening situation on inter-bank markets primarily influenced the low accessibility of long-term foreign loans, which is reflected in the increase in short-term borrowing abroad.

## Introduction

The Slovenian financial sector, in comparison to other EU Member States, is relatively underdeveloped, while noticeable shifts in development have only been made in recent years, primarily in the banking sector, where lending activity has been strengthened and integration in international monetary and capital flows is increasing. Considering the importance of the level of development of the financial sector for the functioning of the entire economy, such shifts increase the possibilities for faster economic growth (Jazbec and Masten, 2004, pg. 95), whereas it is of key importance that this development is sound and that faster development does not increase the risk related to higher exposure to external shocks.

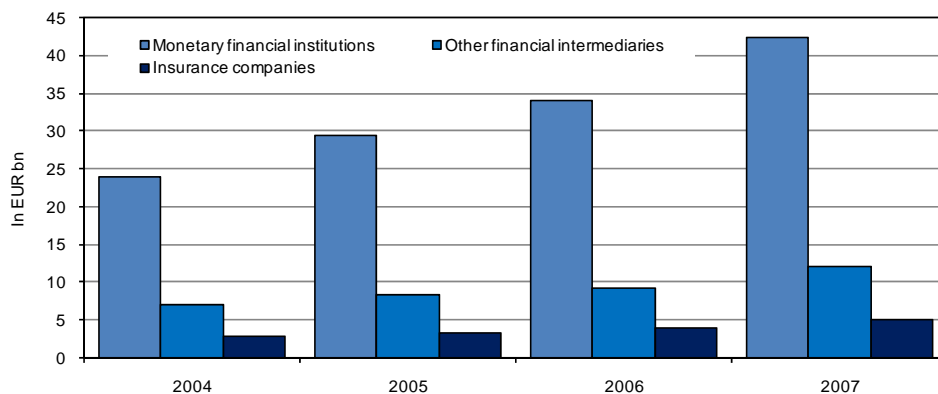
This analysis focuses primarily on the development of the Slovenian banking sector and the movement of financial flows at home and abroad in recent years. Analysis of the lending activity of banks, household savings, borrowing abroad and other capital flows with foreign countries in recent years determines the main trends and their importance for the development of the banking sector. In the final section we present the impact of the international financial crisis, which started in August 2007, on the financial sector in developed economies and assess the possible consequences for the Slovenian banking sector and economy.

## 1. Development of the financial sector

### 1.1. The financial sector in Slovenia and its development in comparison to the EMU

In the Slovenian financial sector, the largest share is held by banks (about 60% of total assets), followed by other financial intermediaries, while the lowest share is held by insurance companies. The structure of the financial sector has not changed considerably in recent years, as all sectors are growing at similar rates.

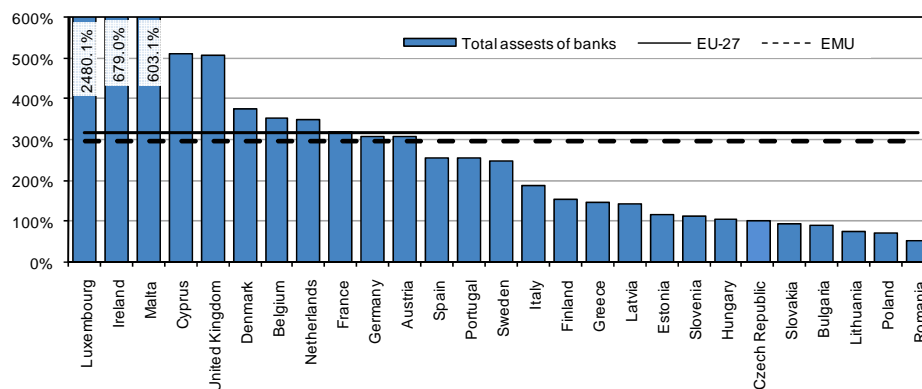
Figure 1: Scope and growth of total assets in individual sectors in the Slovenian financial sector in the 2004–2007 period



Sources: Bank of Slovenia, Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES)

Indicators of development in the Slovenian banking sector show that the lag behind the EMU average is still significant but slowly decreasing. The most important segment of the Slovenian financial sector is banking, where relatively faster progress has been recorded only in recent years, when interest rates decreased noticeably because of membership in the EMU, while exchange rate risk was considerably limited after 2004, and especially from 2007, which boosted the lending activity of banks and, consequently, the growth of their total assets. Despite this, Slovenia records only a third of the EMU average according to the indicator of total assets of banks in comparison with GDP.

Figure 2: Comparison of total assets in GDP in 2006



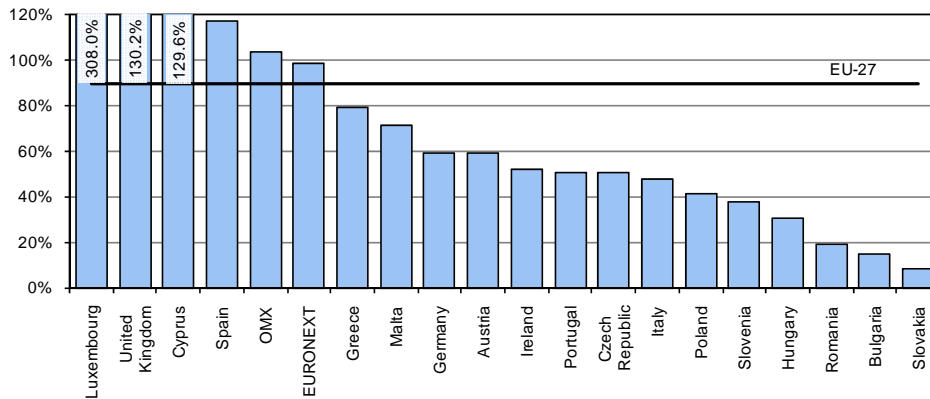
Sources: Statistical Office of the Republic of Slovenia (SORS), Eurostat, Bank of Slovenia, ECB, LBo, Slovenian Insurance Association, Sigma: World Insurance in 2006

In terms of the development of financial services, Slovenia is the closest to the EU average in the area of the capital market and lags behind somewhat more in insurance.<sup>2</sup> The market capitalisation of shares on the Ljubljana Stock Exchange almost tripled over the last two years. A large part of the growth is the consequence of the growing value of shares, and an important contribution was made by the listing of certain state-owned companies on the stock exchange. At the end of 2007, the indicator of the market capitalisation of shares compared to GDP reached about two thirds of the EU average. Because of a greater decline in the market capitalisation of shares in the first quarter of 2008, the difference could increase again. A somewhat larger development gap than on the capital market is recorded in the area of insurance (about 60% of the EU average), where the gap was not reduced in 2006 for the second consecutive year. Only the structure of insurance premiums is improving gradually, to the benefit of more developed financial services (life insurance), while life insurance still represents less than a third of all premiums, or about half the EU average.

<sup>2</sup> Measured only by market capitalisation of shares in GDP. We are aware that this is a synthetic indicator which by no means can represent the entire situation in the financial sector, but it is frequently used in international comparisons for measuring development of the capital market.



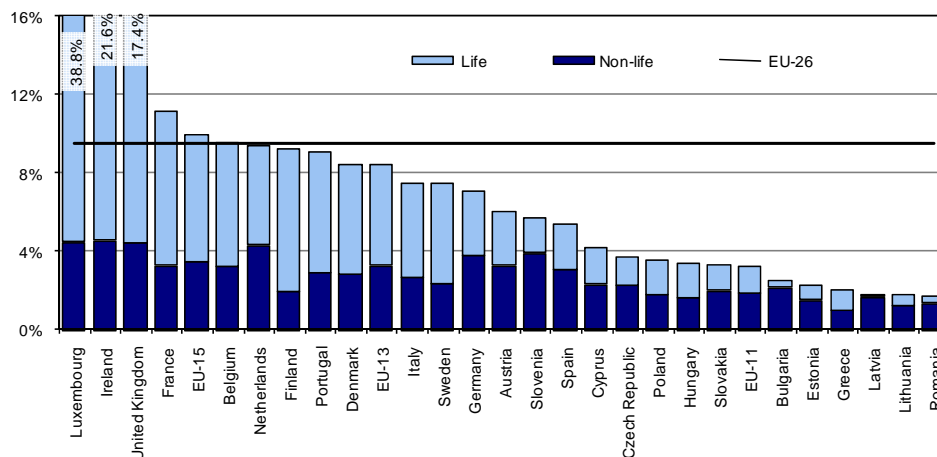
Figure 3: Market capitalisation of shares relative to GDP in 2007



Sources: SORS, Eurostat, LBo

Note: EURONEXT: since 01/2001: Amsterdam-Brussels-Paris; since 02/2002: + Lisbon, OMX: Nordic and Baltic market

Figure 4: Insurance premiums relative to GDP in 2006



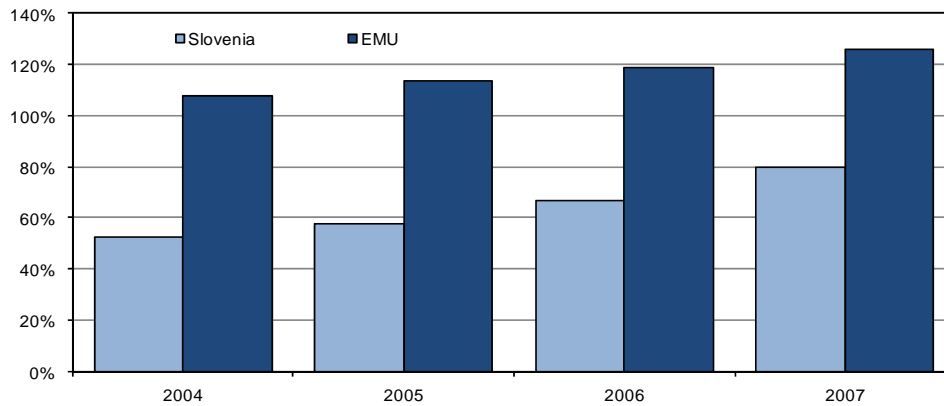
Sources: SORS, Eurostat, LBo, Slovenian Insurance Association, Sigma: World Insurance in 2006

## 1.2. Comparison of the Slovenian banking sector with banking sectors in the EMU

*Comparison of the Slovenian banking sector with the EMU shows that it is relatively underdeveloped.* The share of total assets of the banking sector relative to GDP in Slovenia reaches only a third of the EMU average (see 1.1.). The volume of bank loans to non-banking sectors compared to GDP in Slovenia is the lowest among EMU countries, and in 2007 reached two thirds of the EMU average, which is almost half more than in the year of accession to the EU (see Figure 5). The difference in the share of loans to companies and non-monetary financial institutions is relatively lower than the share of credits to households

*The lag behind the EMU average in the share of loans to companies and non-monetary financial institutions is relatively small.* In terms of the share of loans to companies and non-monetary financial institutions compared to GDP, Slovenia is only slightly behind (just over 2 percentage points) the EMU average, which stood at 60% in 2007. The share of loans to companies compared to GDP (without non-monetary financial institutions) already exceeds the EMU average. Reasons for the relatively great importance of bank loans in the financing of the entrepreneurial sector can be found in the structure of the Slovenian financial system, which is bank-oriented, and in insufficient development of the financial sector and the shallowness of the domestic financial market. Other possibilities for financing companies are rather limited.<sup>3</sup> Also, in some comparably developed EU Member States (Portugal and Spain) similar reasons influence the high dependence of companies on the banking system, and the share of loans to companies compared to GDP in these countries considerably exceeds the Slovenian level.

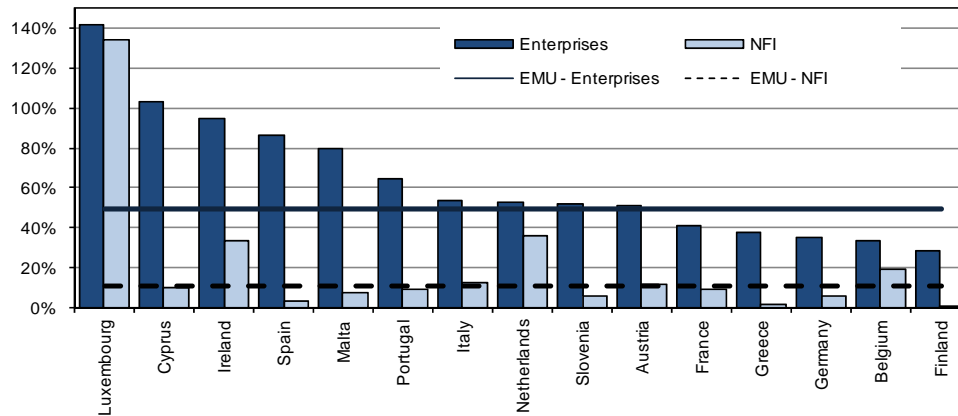
Figure 5: Comparison of shares of loans to the non-banking sector relative to GDP in the 2004–2007 period



Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

<sup>3</sup> The first phase of privatisation of the second largest bank, which took place through an initial public offering, could also contribute to a larger role of other segments of the financial market. Considering the great interest from investors, other potential issuers also opted for such a way of acquiring financial assets, but in the first half of the year the situation on the capital market was rather unfavourable to this way of financing. One of the possible sources of financing is also venture capital funds, but this activity is still underdeveloped despite the adoption of the legal framework.

Figure 6: Comparison of shares of loans to companies and non-monetary financial institutions in GDP in 2007



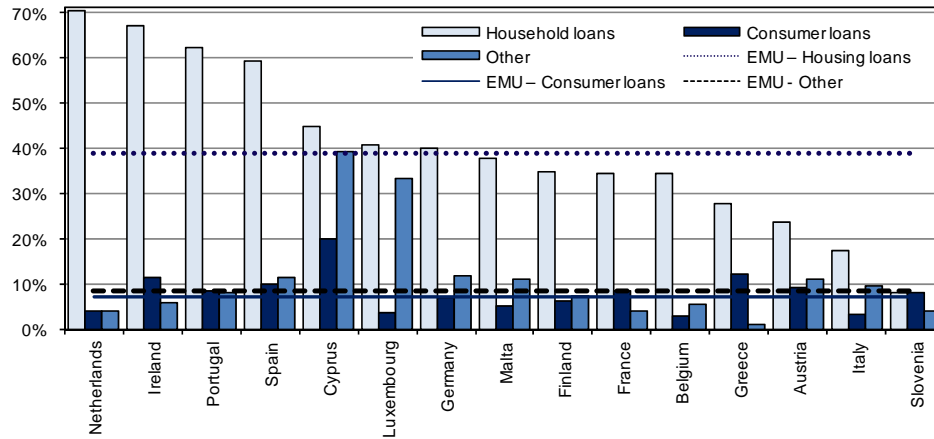
Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

Household borrowing in Slovenia is still relatively low, primarily because of the low share of housing loans in GDP in comparison to the EMU average. In developed financial systems, an important part of lending activity is represented by household borrowing, and despite relatively extensive borrowing in recent years, Slovenia is still the least indebted among all EMU members (in relation to GDP). The average indebtedness of households, measured in the share of loans in GDP, in 2006 stood at 54.3% in the EMU, and at 44.8% in the EU. The share of loans to households in GDP in Slovenia stood at 20.3% of GDP in 2007. The lag is still largest in the area of housing loans, as their share of GDP accounts for only a fifth of the EMU average (see Figure 7). The total share of consumer loans and loans for other purposes in GDP in 2007 in Slovenia was lower by a fifth than in the EMU, where it stood at around 15.7% in recent years. A more detailed comparison shows that Slovenia exceeds the EMU average in the area of consumer loans, which, however, grow considerably more slowly than housing loans. The share of household credits for other purposes amounts to only half of the EMU level.

The volume of housing loans in Slovenia is relatively low, but these have recorded the highest growth rates among household credits in recent years. Reasons for the relatively small volume of housing loans include the modest development of their supply in the past, relatively favourable conditions for the purchasing of apartments in the privatisation process in the first half of 1990s – as a consequence there was no increased demand for such loans at that time – and also in the relatively underdeveloped institutional framework,<sup>4</sup> where only in recent years have there been gradual improvements, which also contributed to faster growth in such financing. Besides increased competition and, consequently, improved offers from banks in this area, the larger volume of housing loans in recent years has also been strongly boosted by lower interest rates.

<sup>4</sup> Difficulties were experienced with land register, unregulated conditions in the area of enforcement (long court proceedings) and mortgage banking.

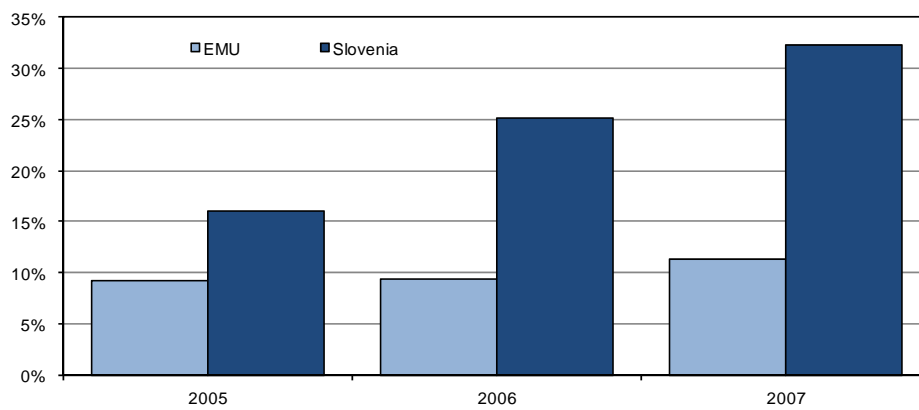
Figure 7: Comparison of shares of loans to households in GDP for 2007



Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

Similar to Slovenia, the lending activity of banks in developed financial systems also improved considerably in the period of high economic growth and low interest rates. The total volume of loans in the EMU in the last three years increased on average by 10% a year, while in Slovenia growth stood at almost 25%, which resulted in catching up more quickly to the EMU average. The highest share is represented by borrowing in the entrepreneurial sector, which in this period recorded a higher rate of credit growth than households.

Figure 8: Comparison of year-on-year rates of growth of loans to non-banking sectors



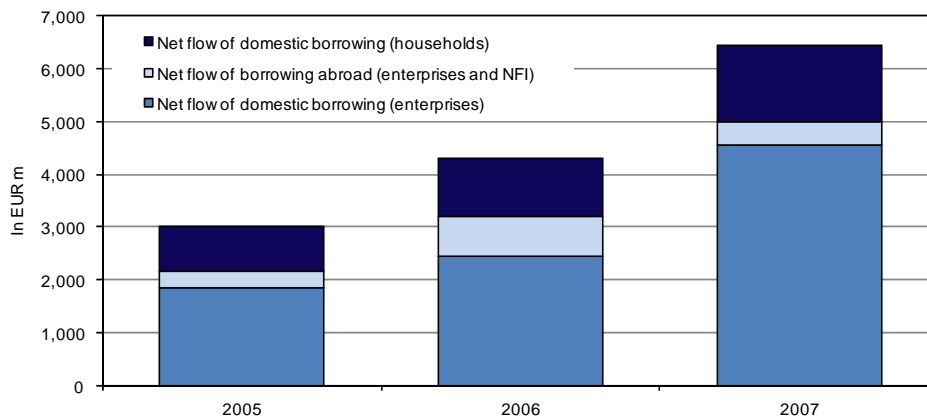
Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

## 2. Analysis of financial trends and flows in banks and mutual funds

### 2.1. Lending activity of domestic banks

*Since Slovenia's accession to the EU, the lending activity of domestic banks has constantly increased.* In the first year and a half after accession, the decrease in interest rates, which started with the process of their convergence towards the EU average in 2003, continued. Household borrowing increased, and borrowing by companies and non-monetary financial institutions increased even more. Foreign currency borrowing recorded the highest growth rates, as interest rates for such credits were more favourable than interest rates for loans in the domestic currency. Furthermore, Slovenia entered the ERM II system at the end of the first half of 2004, which considerably decreased exchange rate risk, as the majority of foreign currency loans were taken in euros. At the beginning of 2004, foreign currency loans represented about a quarter of total bank loans to non-banking sectors, and before Slovenia's entry into the EMU their share increased to almost two thirds. Since a large portion of foreign currency loans were denominated in EUR, their share dropped to less than 5% after Slovenia's entry into the EMU (the majority being represented by loans in CHF, and to a lesser extent in GBP and USD).

Figure 9: Net flows of borrowing of households, companies and non-monetary financial institutions from domestic banks and abroad

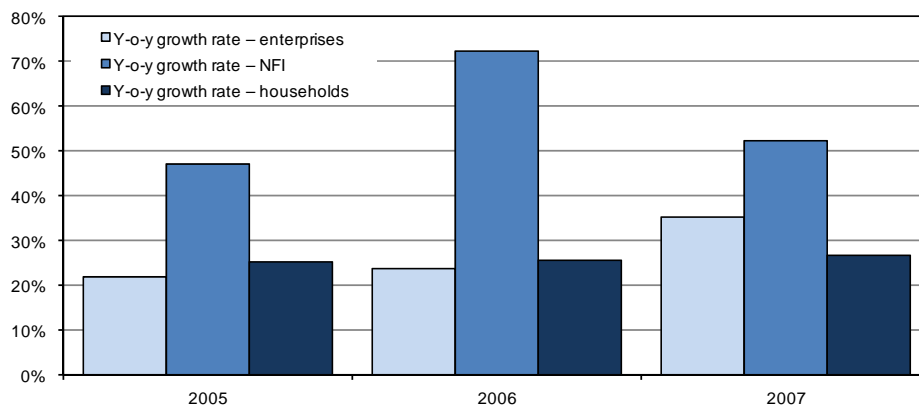


Source: Bank of Slovenia, calculations by IMAD

Increasing growth in borrowing was largely contributed by companies and non-monetary financial institutions, which represented 80% of the total net borrowing of domestic non-banking sectors. Companies and non-monetary financial institutions gradually shifted after 2004 from borrowing on foreign markets to domestic borrowing, because of the convergence of interest rates and the improved loan conditions resulting from increased competition among banks in Slovenia. Decreasing interest rates thus additionally stimulated demand from companies and non-monetary financial institutions for loans, which in those years also increased due to favourable economic conditions in the international environment, which positively influenced domestic economic activity. Moreover, demand for loans was

additionally strengthened by relatively high takeover activity in recent years. According to the Bank of Slovenia, non-monetary financial institutions, which especially in previous years strongly increased their borrowing, were particularly active in takeovers; growth in bank loans to these institutions exceeded 50% (the share of non-monetary financial institutions within loans to companies and non-monetary institutions at the end of 2007 represented 10.1%). In 2007, low real interest rates, which were mainly a consequence of relatively higher inflation in Slovenia compared to the EMU average, also contributed to the growth in borrowing.

Figure 10: Year-on-year rates of growth in loans to non-banking sectors in domestic banks

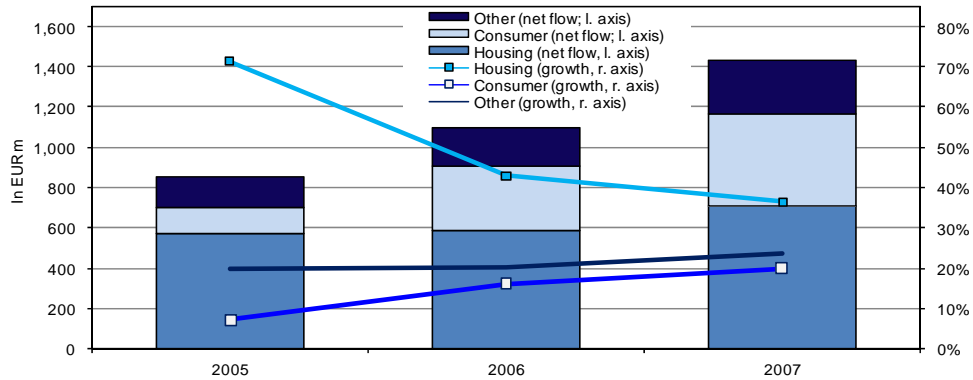


Source: Bank of Slovenia, calculations by IMAD

*Similar to companies, households also considerably increased their volume of borrowing in this period.* Household borrowing for purchasing apartments increased the most, and, as such, loans in the period between 2005 and 2007 increased by 50% a year on average, and their net flows represented about a half of overall net household borrowing (see Figure 11). The maturity of housing loans was also extended; as before, the share of loans with maturity over 15 years reached less than a third of all loans, while in 2007 it already exceeded 60%. Before the introduction of the euro, households primarily took foreign currency loans, while their importance decreased after the introduction of the euro, which became the domestic currency, but this decrease was lower than for companies.<sup>5</sup> The Bank of Slovenia notes that a large portion of foreign currency loans are denominated in Swiss francs, as borrowing in this currency was more favourable in terms of interest rates than in euros. The rapid growth in foreign currency loans was additionally stimulated by favourable movements of the value of the Swiss franc in comparison to the euro in the period between 2006 and 2007. The share of net flows of foreign exchange loans considerably increased at the beginning of this year, while the value of the Swiss franc in comparison to the euro was changing more than in previous years, which means that households were more exposed to foreign currency risk in this area of borrowing.

<sup>5</sup> Before the adoption of the euro, the share of foreign currency borrowing stood at about 80% and then dropped to about 30%, while companies and non-monetary financial institutions previously borrowed only in the form of foreign exchange loans, and then their share dropped to a tenth.

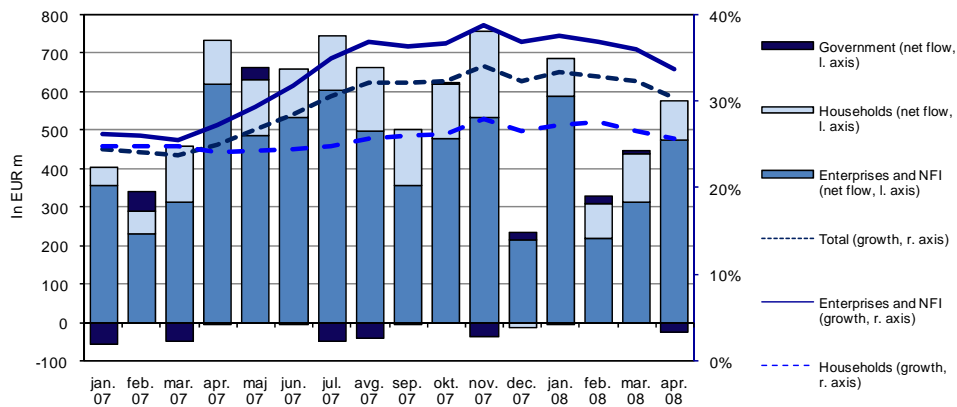
Figure 11: Net flows of household borrowing and year-on-year nominal growth rates for loans



Source: Bank of Slovenia, calculations by IMAD

After relatively high growth in January 2008, the lending activity of domestic banks slowed considerably in the following three months. Net flows in the first four months of this year were, at EUR 2,010.9m, only a tenth higher than in the comparable period last year, which is considerably lower growth than in previous years. There are several reasons for the slowing down of growth, on both demand and supply sides. The lower demand is primarily influenced by higher interest rates, which are a consequence of the international financial crisis.<sup>6</sup> On the other hand, because of the consequences of the international financial crisis, banks are facing more difficulties acquiring financing from abroad (especially those which are not owned by foreign banks), which influences their supply of loans. The year-on-year rate of credit growth in the first four months still remained at a relatively high level, but it decreased in April for the third consecutive month and stood at 30.4%, which is the lowest rate in the last ten months.

Figure 12: Net flows of domestic bank loans to non-banking sectors and year-on-year growth rates for loans



Source: Bank of Slovenia, calculations by IMAD

<sup>6</sup> The onset of the crisis also resulted in an increase of referenced interest rates on monetary financial markets (the 3-month EURIBOR in May was 0.6 percentage points higher than before the outbreak of the financial crisis; see Section 6).

***Borrowing of companies and non-monetary financial institutions also dominated in the first four months of the year.*** More than three quarters of the net borrowing of the non-banking sector in this period went to companies and non-monetary financial institutions, which amounted to a net borrowing of EUR 1,590.7m, which is only about 5% more than in the same period the year before. Over half were loans for working capital, which lagged behind the same period the year before by over a fifth – this can also be linked to a gradual deceleration in the growth of production activity. On the other hand, net flows of loans for investment and other purposes increased by over a third. The high growth of net flows of loans for other purposes (80%) was most probably linked chiefly to the financing of takeover activities of companies. The importance of borrowing abroad as a source of financing companies continues to decrease, as companies took loans in the first three months of the year in the net amount of EUR 89.8m, which is only a third of the amount from the same period the year before. Besides slight differences between foreign and domestic interest rates, this decrease was also influenced by the limited availability of loans on foreign markets.

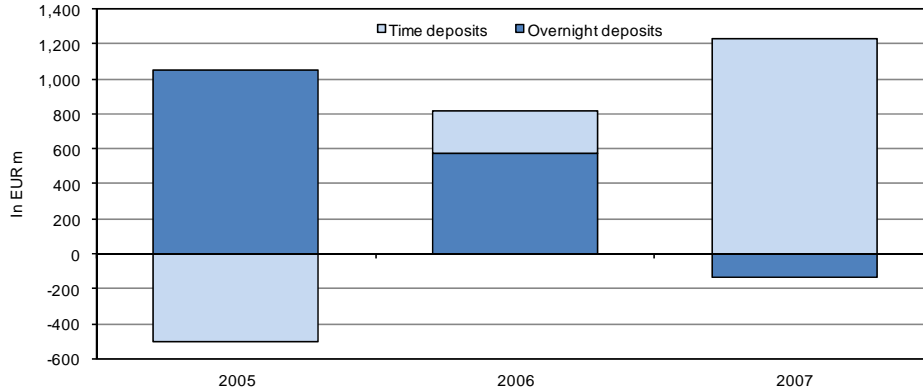
The growth of household borrowing in the first four months of the year decreased more slowly than the borrowing of companies and non-monetary financial institutions, which is primarily a consequence of further extensive borrowing in the form of housing loans. In the first four months of the year, households borrowed a net EUR 417.0m, which is 13.7% more than in the same period last year. The biggest share was in net flows of housing loans, which in the first four months of the year reached EUR 285.2m, which is 50% more than in the same period last year. On the other hand, net flows of consumer and other loans in the first quarter of the year decreased by a quarter over the same period last year. This lower amount of such net borrowing is most probably a consequence of negative trends on capital markets and, consequently, the smaller volume of household borrowing for the purchase of securities.

## **2.2. Household savings in banks and mutual funds**

***The reduction of interest rates has influenced lower growth rates of household savings in banks.*** The net inflow of term deposits slowed down considerably in 2005, while net inflows of more liquid deposits (overnight deposits) took on a more important role among household deposits in banks (see Figure 13). These trends changed in 2006 and 2007, as term deposits started gaining ground. This is especially the case with deposits redeemable at notice, which have higher interest rates. One reason for higher growth rates could also be the higher growth of net wages and the gradual increase in deposit interest rates. The growth of net wages was higher in income groups with a higher propensity to savings and is a consequence of lower progression in the new income tax legislation, which entered into force in 2007. Increasing interest rates in the first half of 2007 were a consequence of the increase in the key interest rate of the ECB, while deposit interest rates later also increased because of worsening conditions on inter-bank markets as a consequence of the financial crisis, as this greatly restricted banks' access to foreign financial assets.

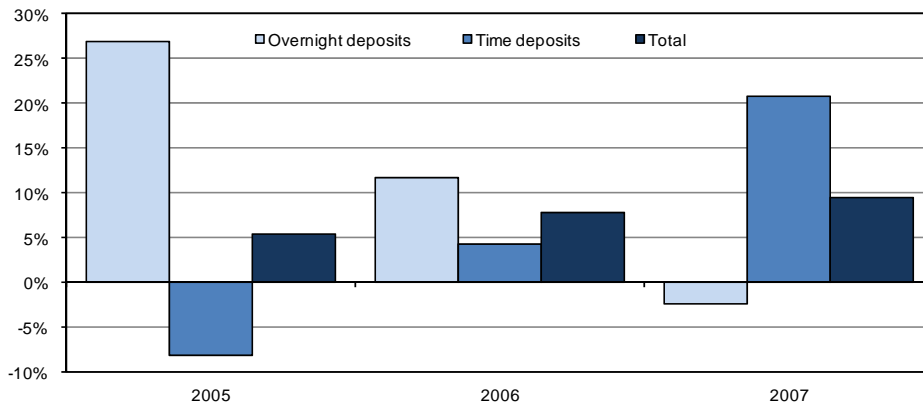


Figure 13: Net flows of household savings in banks



Source: Bank of Slovenia, calculations by IMAD

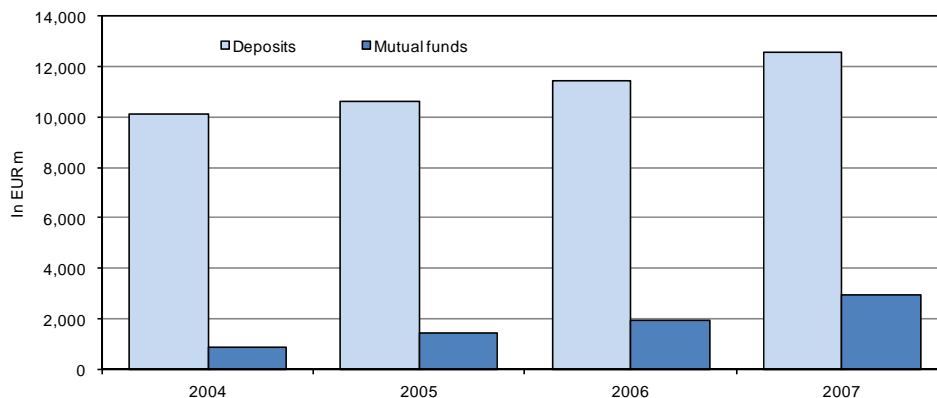
Figure 14: Year-on-year growth rates of household savings in banks



Source: Bank of Slovenia, calculations by IMAD

The reduction in interest rates, favourable trends on capital markets at home and abroad (up to last August), increased domestic and foreign investing options and intensive marketing have contributed to the strong increase of household savings in mutual funds in recent years. In the 2004–2007 period, the volume of assets in domestic mutual funds increased on average by two thirds per year (see Figure 15). Year-on-year yield in individual mutual funds meanwhile exceeded the 50% level. High yields encouraged investors to make more bold investments in equity funds, as their shares more than doubled in this period and at the end of 2007 represented almost two thirds of assets in domestic mutual funds.

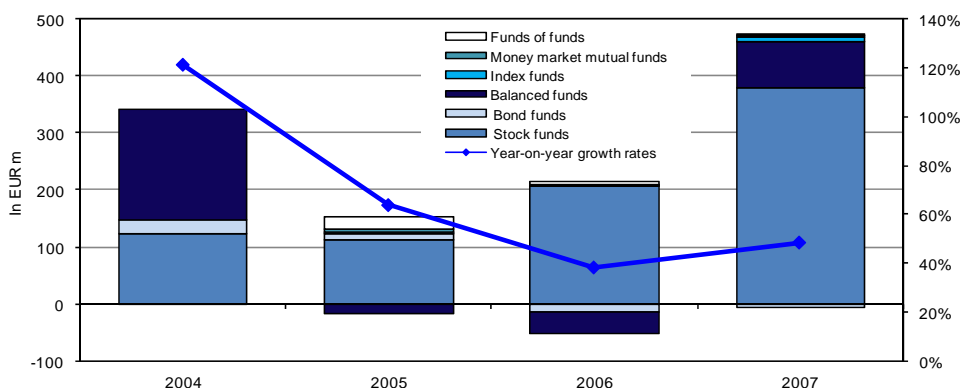
Figure 15: Volume of household savings in banks and mutual funds



Source: Securities Market Agency, calculations by IMAD

*The volume of assets in mutual funds at the end of last year accounted for almost a quarter of household savings in banks.* Net flows in mutual funds accounted on average for just under 30% of net flows of household deposits in banks. Despite high growth in recent years, an international comparison shows that mutual funds in Slovenia continue to be a relatively less important form of saving than on average in the EMU, where assets per citizen exceed EUR 15,200,<sup>7</sup> while this amount in Slovenia stands at a mere EUR 1,200. A comparison with GDP also shows that the difference is considerable, as the share of assets in mutual funds in Slovenia in 2006 stood at 6.5% of GDP, and in the EMU at 57.2% of GDP.<sup>8</sup> Pension funds are also gradually gaining importance, as their volume of assets increased by a factor of 7.5 in the 2004–2007 period, but at EUR 439.1m at the end of 2007 reached only 15% of the assets in domestic mutual funds.

Figure 16: Net deposits in mutual funds and year-on-year growth rates for assets in domestic mutual funds



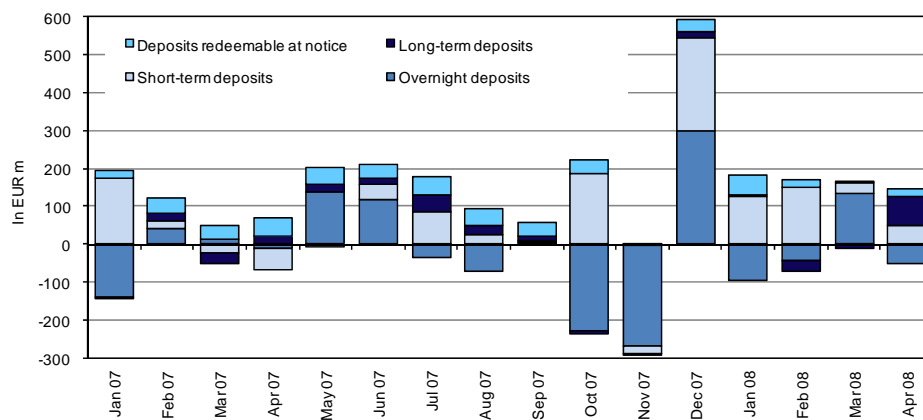
Source: Securities Market Agency, calculations by IMAD  
Note: MMMF: Money Market Mutual Funds

<sup>7</sup> Data for 2006. There is no data for Malta and Cyprus, while data for Ireland and Luxembourg, which considerably stand out from the average, were also included. The average without these two countries would only exceed EUR 8,300.

<sup>8</sup> See note 7.

*In 2008, household savings, with worsening conditions on international financial markets, are again gaining more importance as a source of financing the lending activities of banks.* Growth in household savings in banks continued to increase with the gradual rise in interest rates and most probably also because of lower household investments in capital markets. The net flow of household deposits in banks in the first four months of the year stood at EUR 437.6m, and exceeded the amount from the same period last month by a factor of nearly 2.5. Term deposits (primarily short-term and redeemable at notice) recorded higher growth rates, while overnight deposits at the end of April were 1% lower than at the end of last year.

Figure 17: Net flows of household savings in banks

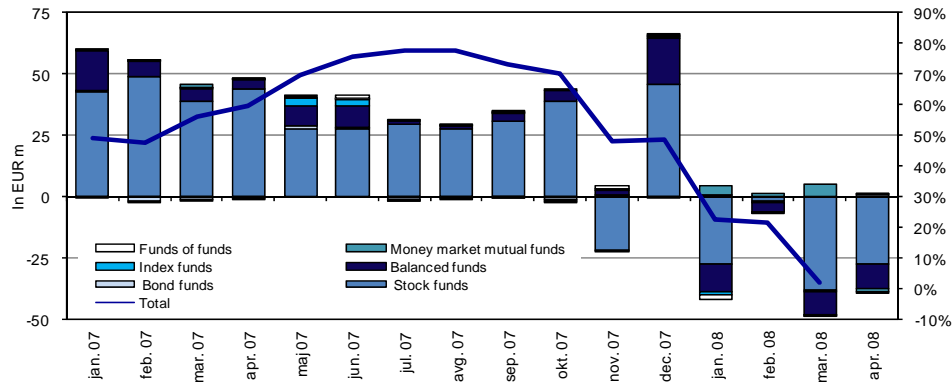


Source: Bank of Slovenia, calculations by IMAD

After a strong boost in the last year, the volume of assets in domestic mutual funds dropped in the first four months of the year by almost a fifth.<sup>9</sup> This drop was largely the result of a decrease in the value of securities on the majority of capital markets, and a quarter of the decrease was a consequence of net outflows of assets from mutual funds, which stood at EUR 123.3m, while in the same period last year net inflow was recorded at EUR 204.6m. The major part of assets of mutual funds is still in equity funds (64.5% of all assets), but their share decreased this year by 1.6 structural points.

<sup>9</sup> A decrease also at the annual level was recorded in April for the first time in the last ten years.

Figure 18: Net flows in individual types of domestic mutual funds and year-on-year rates of the overall volume of assets



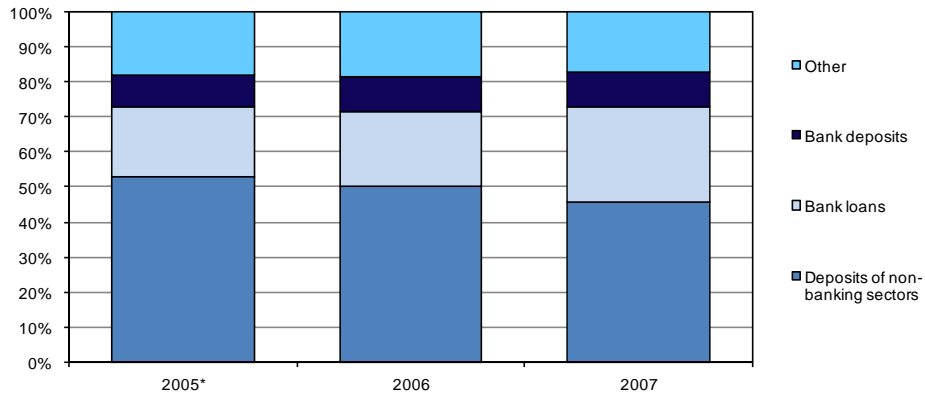
Source: Securities Market Agency, calculations by IMAD

### 2.3. Changes in the structure of liabilities in the total assets of domestic banks

Low growth rates for bank deposits and high demand for loans in recent years have led to boosted external bank funding. Banks financed a large part of their lending activities by borrowing abroad, which has been increasing year by year and in 2007 exceeded EUR 3.3bn (see Figure 20). The international financial crisis that began in August 2007 considerably changed the structure of this kind of borrowing. Before the crisis, banks borrowed mostly in the form of long-term loans, but worsening conditions on the inter-bank market forced them to settle for short-term borrowing. Considering that these assets are still loaned long-term,<sup>10</sup> this worsens maturity matching of the balance sheet and consequently increases liquidity risk. An important source of financing was also deposits of foreign banks, which fluctuated in the last three years at around EUR 1bn. Considering less accessible external sources of financing this year, banks are also resorting to capital injections in order to acquire additional assets, which is a consequence of the fact that the capital adequacy of the majority of banks did not follow the high lending activity, while additional capital requirements are also imposed by the implementation of the Basel II Framework.

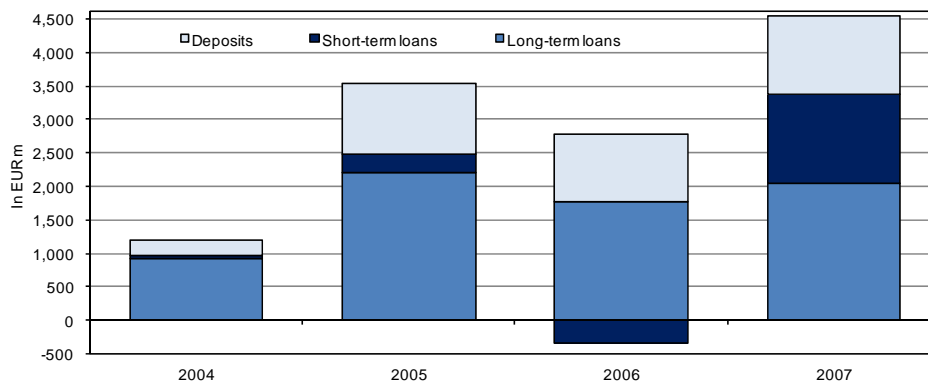
<sup>10</sup> On the basis of data from financial accounts we estimate that banks granted about two thirds of overall net flows in long-term loans.

Figure 19: Changing liability structure in banks



Source: Bank of Slovenia, calculations by IMAD  
Note: \*Data for January 2006.

Figure 20: Structure of net borrowing of banks abroad

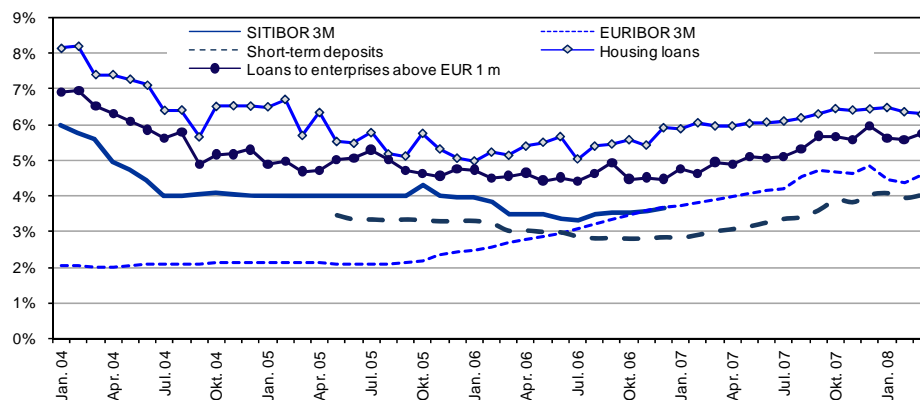


Source: Bank of Slovenia, calculations by IMAD

## 2.4. Interest rates

Lower inflation and the elimination of indexation of interest rates have in recent years considerably reduced the level of interest rates, which by the end of 2006 converged towards the EMU level. As a year before Slovenia's entry into the EMU the ECB started to gradually raise the main interest rate, the convergence was faster. After entry into the EMU, interest rates in Slovenia again started to rise, which was initially a consequence of the restrictive monetary policy measures of the ECB, which at the end of 2005 started gradually raising interest rates, while increases in the second half of 2007 were related to the worsening conditions on financial markets because of the international financial crisis.

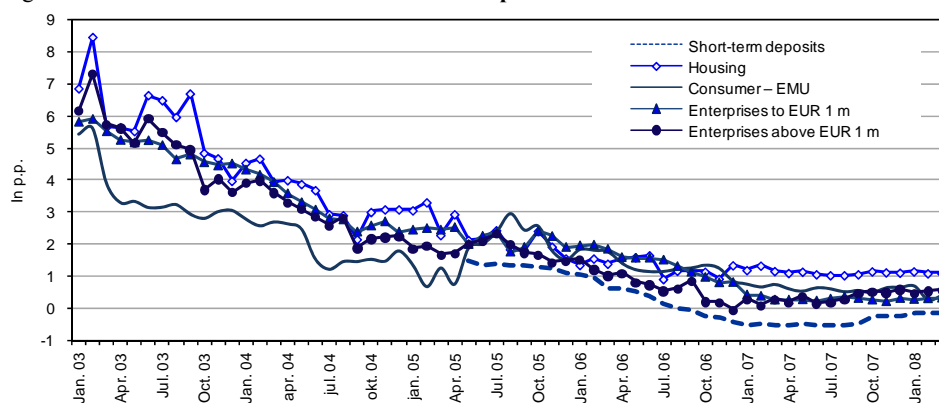
Figure 21: Movements of certain interest rates



Sources: Bank of Slovenia, www.euribor.org, calculations by IMAD

In Slovenia, banks lowered deposit interest rates more rapidly, and they have remained below the EU average for more than a year and a half. On the other hand, lending interest rates are above the EMU average. The most significant differences between Slovenia and the EMU are recorded in interest rates for household credits as individuals have limited access to foreign borrowing.<sup>11</sup> For housing loans, interest rates are 1.2 percentage points above the EMU average, while the differences between interest rates for consumer loans and loans to companies are somewhat lower. A greater difference between lending and deposit interest rates points to still insufficient competition on the Slovenian banking market.

Figure 22: Movement of differences between comparable interest rates in Slovenia and the EMU



Sources: Bank of Slovenia, calculations by IMAD

<sup>11</sup> The volume of borrowing is too small in the majority of cases to justify the hiring of financial advisers, while foreign banks are more careful in loaning because of a relatively small amount of available information.

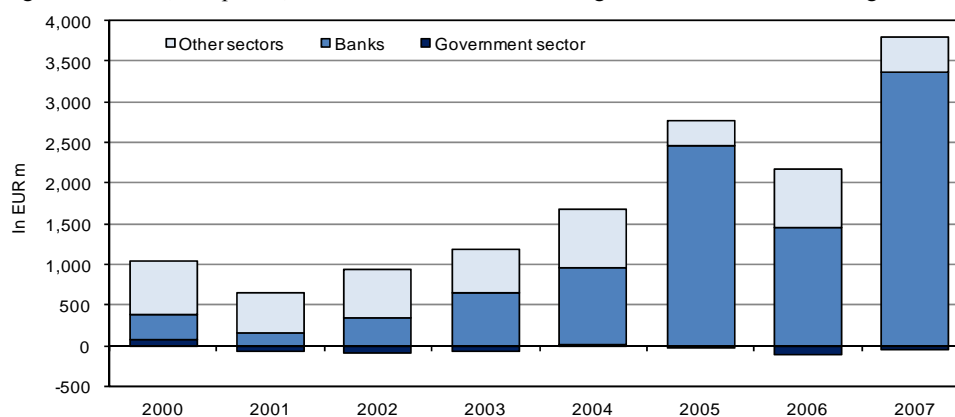
*Net borrowing by domestic banks abroad increased slightly at the end of the year, but still remained below the average rate from the previous year.* After net repayment of short-term loans in January, such credits in the remaining months of the first quarter regained importance within bank borrowing abroad. The overall net flows of foreign loans (short-term and long-term) in this period stood at EUR 561.6m, and in the same period last year banks even repaid foreign loans in the amount of EUR 208.3m. The needs for such financing were smaller then because banks obtained additional financial assets when the bills of the Slovenian central bank matured.

### 3. External Financial and Capital Flows

#### 3.1. Borrowing Abroad

*Upon entering the EU and EMU, Slovenia's integration in international financial and capital outflows strengthened.* The following factors in particular influenced the increased volume of international financial and capital flows, assets as well as liabilities: firstly, the full liberalisation of the capital and financial account of the balance of payments during accession to the EU; and secondly, the adoption of the euro in 2007.

Figure 23: Banks, companies, other financial institutions and government sector borrowing abroad



Source: Bank of Slovenia

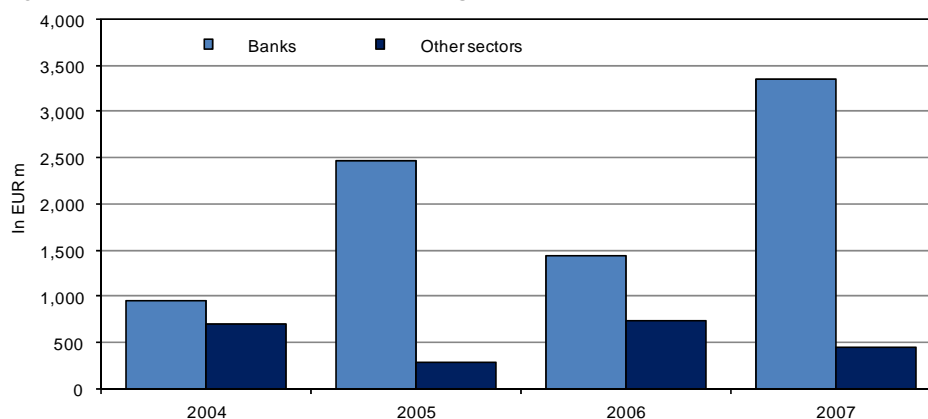
*Borrowing abroad has strengthened since 2003; in the past four years especially domestic bank borrowings abroad have grown rapidly.* In the period after 2003, more borrowing by the banking sector was encouraged by the slower depreciation of the tolar (SIT) against the euro, together with domestic and foreign interest rate convergence prior to and following Slovenia's accession to the EU, which on the one hand influenced the slower growth in deposits in domestic banks, and on the other influenced the increase in demand for credit among companies and households. With lower growth in domestic sources of financing, domestic commercial banks started to increase the volume of borrowing abroad, in particular after 2004. In this way they provided the means for increased demand for credit<sup>12</sup> in other sectors (in particular from companies). In addition, after entering the EMU in 2007, the elimination of exchange rate risk in borrowing in euros (borrowing in euros represents around 90% of total external debt) and lower risk premiums, which increased the availability of foreign loans, also impacted the increased volume of foreign borrowing. Direct company borrowing abroad gradually decreased after 2004 and was redirected to borrowing from domestic commercial banks. Growth in borrowing abroad by the banking sector, the majority of which is represented by long-term loans, was

<sup>12</sup> Moreover, the raising of loans abroad was joined by received payments in cash and foreign bank deposits as important sources of financing on domestic banks balance sheets (see Section 2.1.3.).



somewhat slower in 2006 and the beginning of 2007, since banks partially covered the increased domestic demand for credits from matured bills of the Bank of Slovenia. In 2006, the greater volume of loans raised abroad by other financial institutions considerably influenced the growth in borrowing abroad.

Figure 24: **Banks and other sectors borrowing abroad**



Source: Bank of Slovenia

***Increased borrowing abroad influenced the growth of gross external debt, which at the end of 2007 stood at 102.4% of GDP.*** Gross external debt amounted to EUR 34,358m at the end of 2007, and was EUR 10,324m higher compared to December 2006. Borrowing by domestic commercial banks, whose growth strengthened last year, contributed EUR 5,197m, or 50.3%. The share of the debt of commercial banks has constantly increased since 2001, and at the end of 2007 represented 47.2% of gross external debt and 48.3% of GDP (as compared to 36.2% of GDP at the end of 2006). Besides the direct raising of foreign loans by banks and companies, as well as other financial institutions, the increase in external debt in 2007 was also the result of the debt of the Bank of Slovenia, incurred by its entry into the Eurosystem. By entering the EMU, claims on the bills and long-term deposits of commercial banks against the Bank of Slovenia decreased. The liabilities of the Bank of Slovenia were replaced by short-term liabilities to the Eurosystem, which greatly increased in particular in the first five months of 2007 (by EUR 3,522.5m), when tolar (SIT) bills matured. The liabilities of the Bank of Slovenia to the Eurosystem thus contributed 34.6% of the increase in gross external debt. Furthermore, long-term Eurobonds issued by the government, which in the case of foreign investments is shown as the gross external debt of the government sector,<sup>13</sup> also contributed to the growth in gross external debt.

***The government sector has in recent years repaid net loans raised abroad and contracted debts mainly by issuing long-term national securities (Eurobonds).*** Strong interest on the part of foreign investors influenced the growth in gross external debt of the government sector in 2007 in particular. Government sector

<sup>13</sup> Resources from the sales of reference bonds of the Republic of Slovenia were partially used to finance the execution of the state budget and partially to finance existing (more costly) debt redemption.

indebtedness increased due to the EUR 1bn in Slobond bonds, equalling EUR 3,026m at the end of 2007, just under one-tenth of the total gross external debt.

***Affiliated companies<sup>14</sup> borrowed abroad relatively less compared to other sectors.*** Affiliated companies borrowed abroad relatively less compared to other sectors until 2007, when their debt increased, which was mainly the consequence of the methodologically broader coverage of direct investment<sup>15</sup> liabilities previously covered as company liabilities in other sectors. As a result, the share of affiliated companies in total external debt decreased from the time of accession of Slovenia until 2007. However, in 2007, it increased by EUR 2,859m to EUR 3,997m, or 11.9% of gross external debt (of this, by EUR 2,035m resulting from methodological changes), as compared with December 2006. Hence, the gross external debt of other sectors largely decreased (to EUR 7,551m) because of the above-mentioned restructuring of part of the loans from other sectors (where companies prevail) among the loans of affiliated companies. Here, debt liabilities to direct investors increased faster than debt liabilities to affiliated companies abroad.

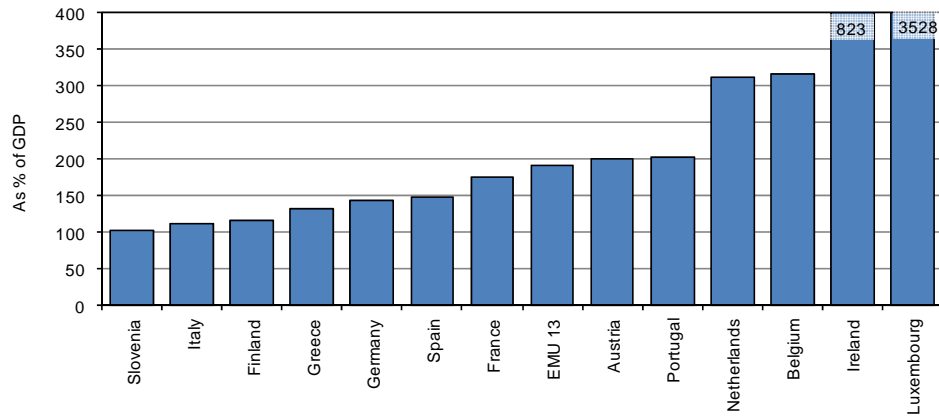
***Most of the gross external debt in 2007 was composed of long-term and non-guaranteed private debt.*** Not considering the liabilities to affiliated companies, for which classification by maturity was not issued, long-term debt accounted for 64.7% and short-term for 35.3% of gross external debt at the end of 2007. This structure, from the point of view of debt maturity, shows that Slovenia has hitherto not experienced problems with liquidity or solvency. This ratio was even more in favour of long-term debt at the end of 2006 (77.3% in relation to 22.7%), but in 2007 an increase in short-term debt occurred, mainly as a consequence of changes in monetary policy instruments, as well as growing short-term indebtedness abroad. The incurred liabilities of the Bank of Slovenia to the Eurosystem last year were the main factor in the increase in public and publicly guaranteed debt, which at the end of 2007 amounted to EUR 8,087m or 23.5% of gross external debt. Guarantees assumed by the Republic of Slovenia for external debt, which are part of the publicly guaranteed debt, at the end of December 2007 amounted to EUR 2,555.7m, which is EUR 597m more than at the end of 2006.

***Slovenia has the lowest share of foreign debt in GDP among the Eurozone countries.*** At the end of 2007, the share of gross external debt was 102.4% of GDP, which is significantly lower than the Eurozone average in 2007 (191.8% of GDP). In the period between 2003–2007 for which there are data available for the Eurozone, the nominal growth of external debt in Slovenia was higher than the Eurozone average (Slovenia 24.9%, Eurozone 14.2%; only in Ireland has external debt increased more than in Slovenia, by 28.7%). Despite almost double the growth of foreign debt in Slovenia compared to the EMU, its share in relation to GDP increased less than in the EMU (from 52.2% of GDP to 102.4%, as compared to 191.8% from 129.0% of GDP in the EMU).

<sup>14</sup> Legal entities affiliated with non-residents who are owners of at least 10% of the capital.

<sup>15</sup> Besides company liabilities to the direct foreign owner, liabilities to all non-resident companies belonging to this group are included among direct investments using the new reporting scheme.

Figure 25: Gross external debt across Eurozone countries, as % GDP



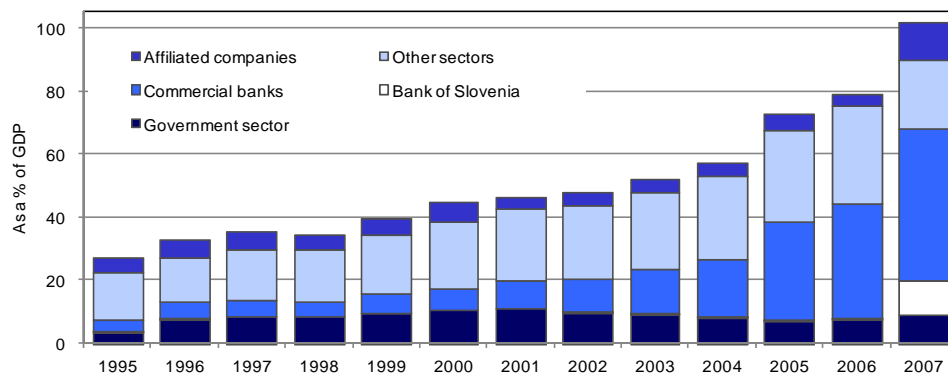
Source: Statistical Office of the Republic of Slovenia (SORS), Bank of Slovenia, World Bank, National Central Banks, recalculations made by the Institute of Macroeconomic Analysis and Development (IMAD)

Table 1: Slovenia's gross external debt, in EUR m

	2000	2001	2002	2003	2004	2005	2006	2007
<b>Total gross external debt</b>	9,490	10,386	11,524	13,225	15,343	20,508	24,034	34,358
Short-term debt	2,283	2,213	2,327	2,475	2,659	4,543	5,206	10,673
Public and publicly guaranteed debt	0	15	99	70	57	40	48	3,588
Private non-guaranteed debt	2,283	2,198	2,227	2,405	2,603	4,503	5,158	7,086
Long-term debt	5,895	7,369	8,229	9,590	11,552	14,551	17,709	19,708
Public and publicly guaranteed debt	2,883	3,095	3,142	3,461	3,689	3,771	4,275	4,499
Private non-guaranteed debt	3,012	4,274	5,087	6,129	7,863	10,780	13,435	15,209
Liabilities to affiliated companies	1,312	804	969	1,160	1,132	1,415	1,118	3,977
Public and publicly guaranteed debt	0	0	0	0	0	0	0	0
Private non-guaranteed debt	1,312	804	969	1,160	1,132	1,415	1,118	3,977

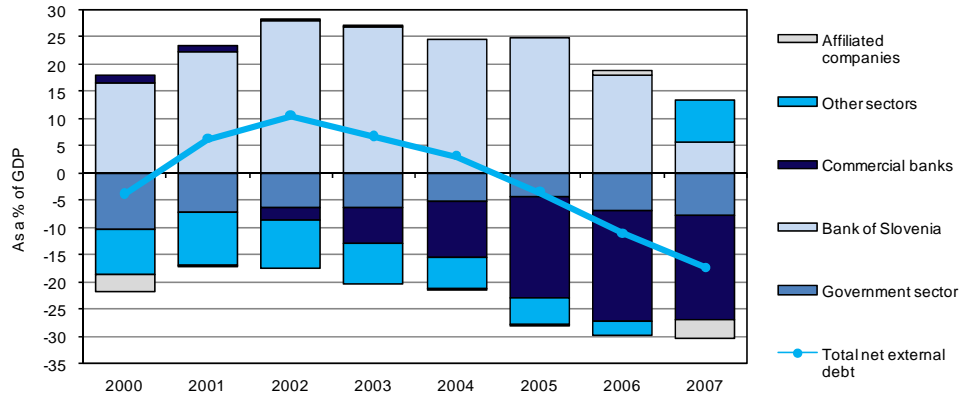
Source: Bulletin of the Bank of Slovenia, April 2008.

Figure 26: Gross external debt by sector, as % GDP



Source: Bulletin of the Bank of Slovenia, April 2008, calculations by IMAD

Figure 27: Net external debt and net claims, as % of GDP



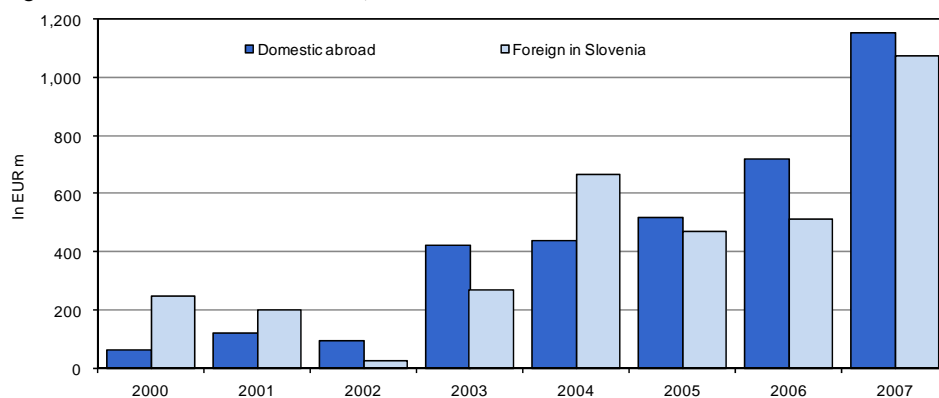
Source: Bulletin of the Bank of Slovenia, April 2008, calculations by IMAD  
Note: the plus sign (+) represents foreign net debt liabilities and the minus sign (-) net external debt.

*Although the outflow of loans increased significantly over the past two years, its volume lagged behind that of inflow of raised loans abroad, hence net external debt increased.* Domestic banks mainly granted loans for financing countries in the area of the former Yugoslavia, while domestic companies were directing loans to borrowers in EU Member States. Regardless of the faster increase in debt claims towards the rest of the world in recent years, the net debt-based position deteriorated and net external debt at the end of 2007 was 18.9% of GDP (compared to 11% of GDP at the end of 2006).

### 3.2. Other capital flows

*Among other capital flows in recent years, direct and portfolio investments of Slovenian investors abroad, which exceeded the investments of foreign investors in Slovenia, increased in particular.*

Figure 28: Direct investment flows, in EUR m



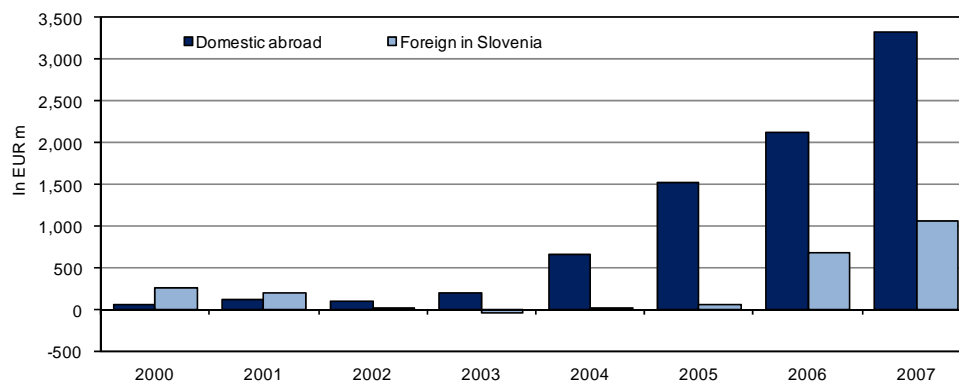
Source: Bank of Slovenia, calculations by IMAD

***In the past three years, direct investment outflows exceeded inflows of foreign investors in Slovenia*** (see Figure 29: **Flows of portfolio investments**)

Slovenian enterprises made the majority of direct investments in countries of the former Yugoslavia. The decreasing share of Slovenian goods exports to this area shows that Slovenia is replacing some of the previous exports with local production in these markets. According to the data available for 2003–2006, Slovenia had the most direct investments in Croatia, namely as much as 42.5%, followed by Serbia and Montenegro, Germany, BiH, Poland and Macedonia. The value of Slovenia’s direct investments abroad consisted, on average, of two thirds of equity capital, while one third comprised net claims to foreign entities affiliated through capital (the difference between the claims and liabilities between affiliated companies). The ratio between equity capital and other capital is increasing and indicates the long-term interest among owners in financing their investments abroad.

***EU countries invested most in Slovenia in the form of direct foreign investments.*** According to data on direct investments in Slovenia by country in the 2003–2006 period, our most important trade partners contributed around two thirds of all direct foreign investments on average. Among the latter, the most important foreign investors were Austria, Germany, France and Italy. Of the EU Member States, with which Slovenian trade flows are modest, the share of The Netherlands represented 5.1% of the value of all investments on average. Of non-EU countries, Switzerland was the largest investor in Slovenia. Equity capital was the most dominant in the value structure of direct foreign investments in Slovenia. At the end of 2006, the total value of equity capital was EUR 5,601.1m. Even though foreign investors, in addition to capital investments also support the current financing of Slovenian enterprises with loans and commercial credits, the share of net liabilities to foreign investors of all foreign direct investments in the past two years declined considerably (to 10.4%, and 8.6% in 2006; it was 12.1% in 2003). Therefore, most direct foreign investment inflows in the past two years occurred in the form of equity capital.

Figure 29: **Flows of portfolio investments**

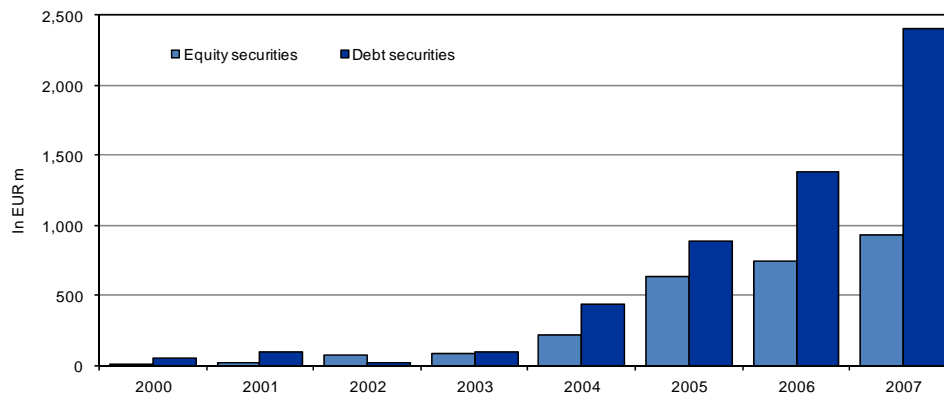


Source: Bank of Slovenia

***Within portfolio investments, the investments of Slovenian investors abroad also exceeded those of foreign investors in Slovenia.*** Among claims,

investments of the private sector in foreign equity shares increased in particular. The increase was especially noticeable in 2005 after the restrictions on investments in foreign securities were abolished, when mutual fund investments increased, and the investments of citizens and insurance companies were higher as well. Investments in foreign securities also increased in 2006 and 2007, but growth rates calmed down somewhat (base effect). The release of liquidity after bills of the Bank of Slovenia matured, most in the first quarter of 2007, heavily increased the investments of Slovenian commercial banks in foreign securities, especially government bonds in the European area. Thus, the portfolio investments of Slovenian commercial banks in foreign bonds, debt obligations and money market instruments increased considerably. Among portfolio liabilities, foreign investment in Slovenian government securities increased in particular in the past two years.

Figure 30: Flows of portfolio investment abroad by type of security

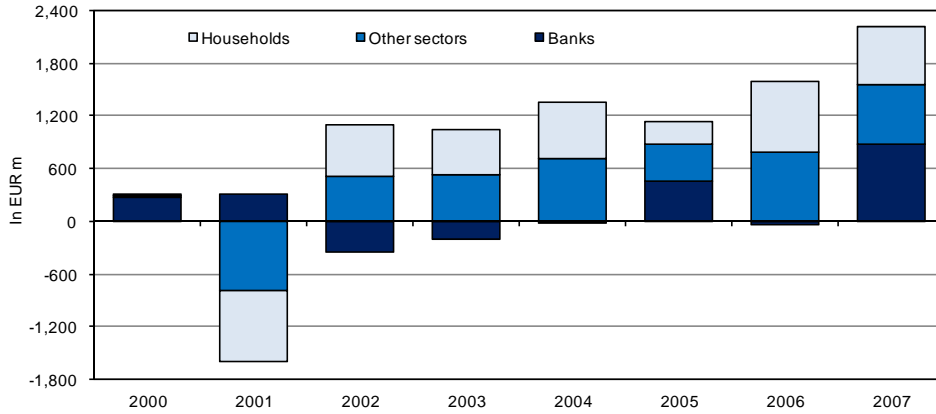


Source: Bank of Slovenia, calculations by IMAD

*The major part of other investments consists of currency and deposits.* The household sector holds the majority of currency and deposits, consisting of cash outside the domestic banking system: 1) foreign currency kept at home, and 2) foreign currency in foreign bank accounts. Before the introduction of the euro, residents brought quite a large amount of foreign currency kept at home to banks to be later converted into euros. Since 2001, outflows under household currency and deposits have remained at a relatively high level. Transfers by non-residents to their families have also been increasing, as well as purchases of residents abroad. Last year's increase was due to changes in methodology.<sup>16</sup>

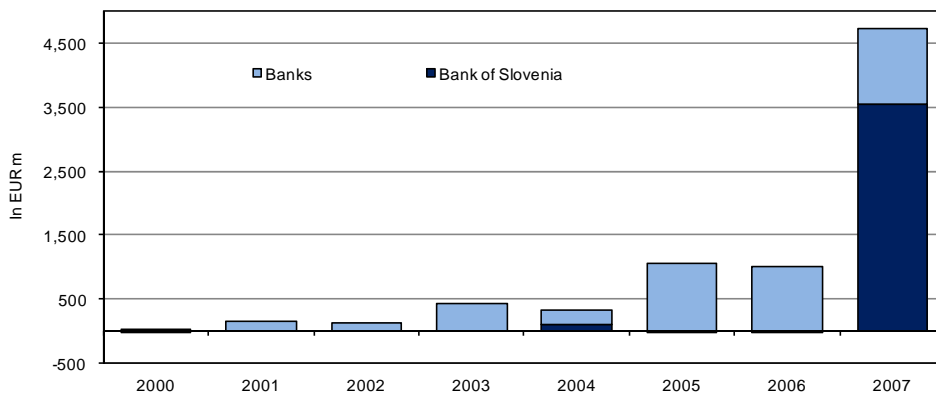
<sup>16</sup> In 2007, the Bank of Slovenia also adopted a new methodology to estimate cash transactions with non-residents, which considerably decreased the statistical error. According to the double-entry bookkeeping principle, cash and deposits of residents represent the counter-entry to travel and labour income. Cash of residents is evaluated as the sum of differences between cash inflows and outflows under tourism and labour income.

Figure 31: Claims on non-residents under cash and deposits



Source: Bank of Slovenia

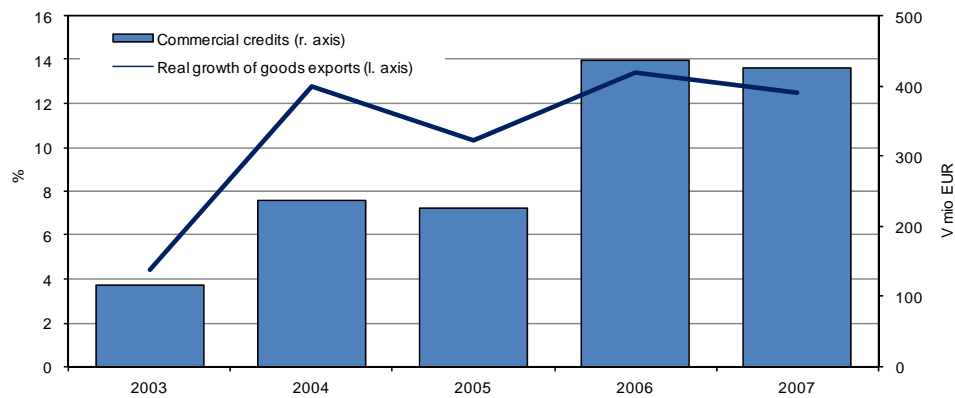
Figure 32: Claims on non-residents under deposits



Source: Bank of Slovenia

*After Slovenia's accession to the EU, flows of short-term commercial credits increased as well, whereby outflows from Slovenia exceed inflows from abroad. Short-term commercial credits are very much connected to the dynamics and structure of goods exports. Slovenia has more than half of claims under short-term commercial credits with EU countries, with which it conducts around two thirds of all flows of goods, and one third to other European countries.*

Figure 33: Short-term commercial credits, in EUR m, and real growth in goods exports in %



Source: Bank of Slovenia, calculations by IMAD



#### 4. BS bills and BS liabilities to the Eurosystem in 2007

*Before entering the EMU, the Bank of Slovenia (BS) gradually adapted monetary policy instruments to existing regulations in the Eurozone.* The operation of BS monetary policy from entering the ERM II exchange rate mechanism to the adoption of the euro focused on stabilising the SIT-EUR nominal exchange rate. Because the fluctuations of market exchange rates around central parity were small, the central bank did not intervene (except in the first month after joining ERM II). Since commercial banks did not require additional liquidity, the instruments for issuing primary money were rarely used (collateralised loan and the temporary purchase of securities). The BS withdrew the larger part of surplus liquidity by selling tolar bills. Due to the planned entry of Slovenia into the Eurozone, the BS gradually adapted monetary policy instruments to the ECB instruments. Tolar bills were being replaced by long-term deposits. It progressively released the minimum prescribed foreign currency liquidity which banks and savings banks had invested in long-term tolar deposits. Finally, the BS purchased foreign currency from the banks under a seven-day swap. Because of the change of monetary and exchange-rate policy instruments, the total amount of tolar bills at the end of 2006 was considerably higher than the total amount of bills in foreign currency.

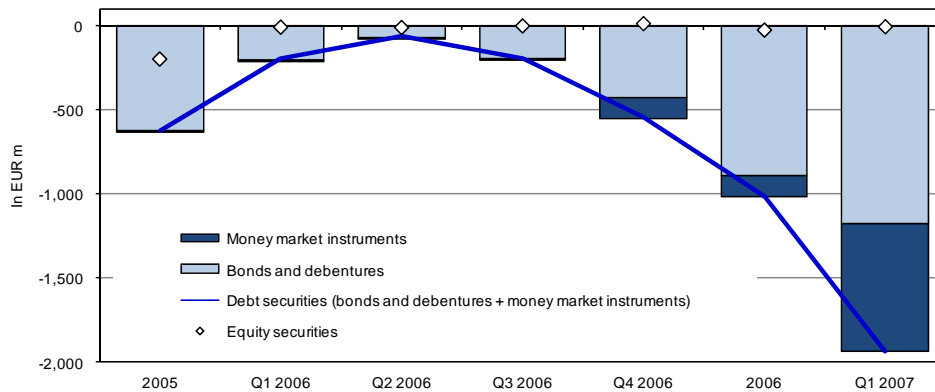
*The process of ensuring a stable currency exchange rate through swap transactions before entering the EMU demanded the strong embeddedness of commercial banks in the transactions of the central bank, which caused the commercial banks to devote relatively less attention to the development of other forms of transactions,* resulting in a negative impact on the development of the financial sector as well as on economic growth (Jazbec and Masten, 2004: 95). In the second half of 2004, the amount of swap transactions began to decrease. But the Bank of Slovenia, in order to put off the increase in liquidity due to the maturity of tolar bills in the period after euro adoption, started to offer banks long-term deposits with an interest rate 0.2 p.p. higher than the interest rate for 60-day tolar bills, thus compensating approximately two thirds of the reduction in swap transactions. This was, however, a continuation of forcing out the banks' other investment activities and an obstruction to deepening the financial sector.

*By adopting the euro, Slovenia has also become a member of the Eurosystem,<sup>17</sup> and monetary policy has thus become a matter of common interest.* By entering the Eurozone, the conditions of borrowing and investment of Slovenian banks at the European Central Bank have equalised with the conditions of other banks in the Eurozone. The instruments used are those of the ECB, which has no bills in the liabilities of its balance sheet. The position of the Bank of Slovenia's bills and long-term deposits was therefore gradually decreasing, so that domestic commercial banks transferred a portion of their capital into foreign securities, particularly into government bonds of the Eurozone. The first quarter of 2007

<sup>17</sup> Since 1 January 1999, the Eurosystem has been responsible for determining and executing common monetary policy of the Eurozone. It consists of the ECB and the central banks of the countries using the euro as the common currency (there are 13 at the moment). The ECB's main objective is to preserve price stability. Beside the main objective, other important objectives exist, such as: foreign currency exchange rate, interest rate, nominal growth of GDP, monetary aggregate M3, etc.

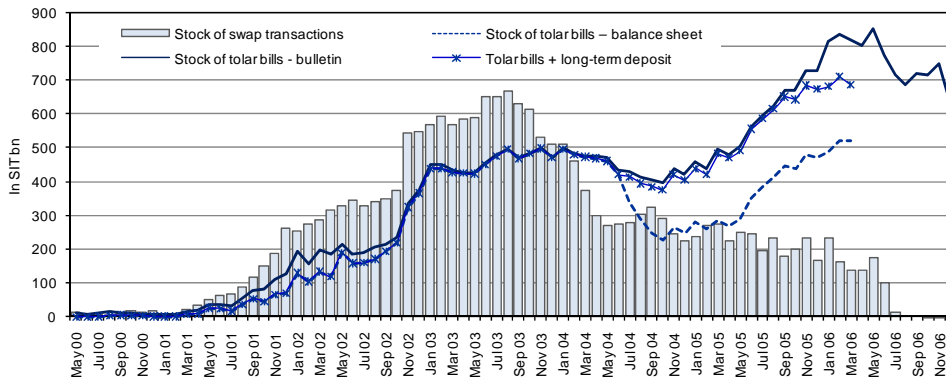
thus witnessed a distinctive increase in the portfolio investments of Slovenian commercial banks in foreign bonds and debt obligations (EUR 1,173.6m) and in monetary market instruments (EUR 761.4m).

Figure 34: Portfolio investments of Slovenian business banks prior to entering the Eurozone and after, flows in EUR m



Source: Bank of Slovenia

Figure 35: Stock of swap transactions and tolar bills of the Bank of Slovenia



Source: Bank of Slovenia

*A less strong bank dependence on transactions with the central bank after entering the EMU will enable faster development in the banking sector.* Despite a gradual deepening, the banking market in Slovenia is still shallow; the volume of banking assets compared to GDP is still below the level that would be in equilibrium with our economic development according to assessments (Jazbec and Masten, 2004: 93). Such a situation indicates that banks probably still do not provide all the necessary services to support faster economic growth; the deepening of the banking and financial sector in general is therefore an important developmental challenge that will also contribute to higher economic growth.

## 5. The international investment position of Slovenia or net financial position

*Upon the liberalisation of the capital-financial account and Slovenia joining the EU, the net financial position<sup>18</sup> changed from surplus to deficit.* After showing a slight surplus (0.1% of GDP) in 2002, the deficit in 2007 was 21.9% of GDP. In claims in the period 2004–2007 (until entering the EMU), there was a noticeable increase in the reserve assets of direct investments abroad and portfolio investments, while the proportion of other investments was decreasing. In liabilities, the proportion of gross external debt or non-equity liabilities in the period 2004–2007 represented nearly 80% of total liabilities, and the remaining 20% was in equity liabilities (equity capital and reinvested profits from direct investments of foreign entities in Slovenia and investments in equity securities). The total international investment position of Slovenia on average showed a net debt position that was EUR 2bn higher than net external debt.

Table 2: International investment position of Slovenia, in % GDP

	2003	2004	2005	2006	2007
1 Debt claims	59.0	60.6	69.3	67.9	83.7
2 Equity claims	3.7	6.2	9.9	14.6	16.8
<b>3 Total claims (1+2)</b>	<b>62.6</b>	<b>66.8</b>	<b>79.2</b>	<b>82.5</b>	<b>100.4</b>
4 Gross external debt	52.2	57.3	72.6	78.9	102.4
5 Equity liabilities	16.3	17.4	17.8	20.7	19.9
<b>6 Total liabilities (4+5)</b>	<b>68.5</b>	<b>74.7</b>	<b>90.4</b>	<b>99.7</b>	<b>122.4</b>
7 Net external debt/claims (1–4)	6.8	3.3	–3.3	–11.0	–18.8
8 Net equity debt/claims (2–5)	–12.6	–11.2	–7.9	–6.1	–3.2
<b>9 Net financial position (7+8)*</b>	<b>–5.8</b>	<b>–7.9</b>	<b>–11.2</b>	<b>–17.1</b>	<b>–21.9</b>

Source: Bank of Slovenia Bulletin (2008)

Note: \*a negative (positive) sign in the balance represents the net debt (credit) financial position.

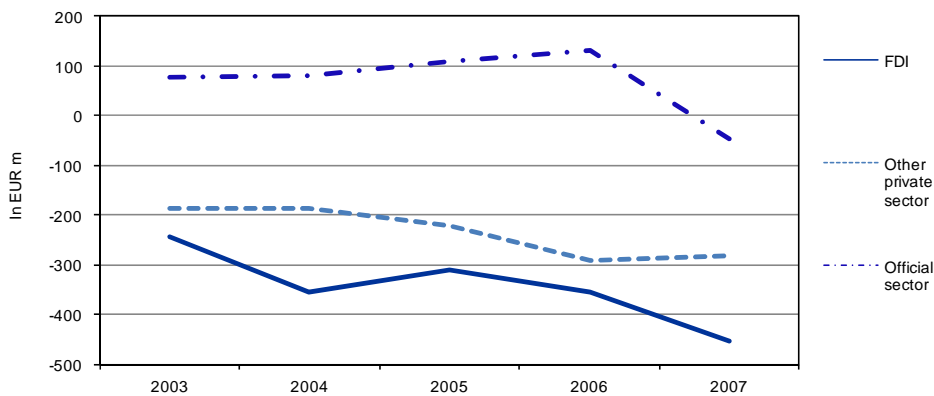
*The faster growth of liabilities rather than claims has, with a relatively lower return on liabilities, influenced the growth of the deficit in the balance of factor income in the current account of the balance of payments.* We estimate that in the period 2003–2007, the implicit nominal rate of return<sup>19</sup> on the total claims of Slovenia (2.6%) was on average lower than the implicit rate of return on total liabilities to foreign countries (4.7%), which has, with a faster increase of liabilities from claims, influenced the growth of net investment expenditure in the current account of the balance of payments. That is, in liabilities, the loans raised in foreign banks prevailed, while in assets as at the end of 2006, the foreign reserve assets of the Bank of Slovenia are composed predominantly of deposits and first-class interest bills that basically bring a lower return. Last year, upon

<sup>18</sup> The international investment position or net financial position indicates the position of total international claims and liabilities of Slovenia at the end of each year, with a structure equal to the structure of the financial account of the balance sheet. Besides debt instruments that are included in gross external claims and gross external debt, it also includes claims and liabilities from equity relations. Changes in the net financial position between two consecutive years reflect transactions in the balance of payments (balance of current and capital account as well as net errors and omissions) and capital gains/losses due to price, exchange rate and other changes.

<sup>19</sup> Implicit rate of return is calculated by comparing the flow of received and paid return on capital (interests from equity and debt capital) in the current year to the position of total claims and position of total liabilities of the preceding year.

adoption of the euro, the foreign reserve assets of the Bank of Slovenia were reallocated to other positions of financial claims, but the Bank of Slovenia property value remained unchanged. Due to the maturity of bills, the liabilities of the Bank of Slovenia to the Eurosystem also increased considerably in the last year.

Figure 36: Investment incomes, in EUR m

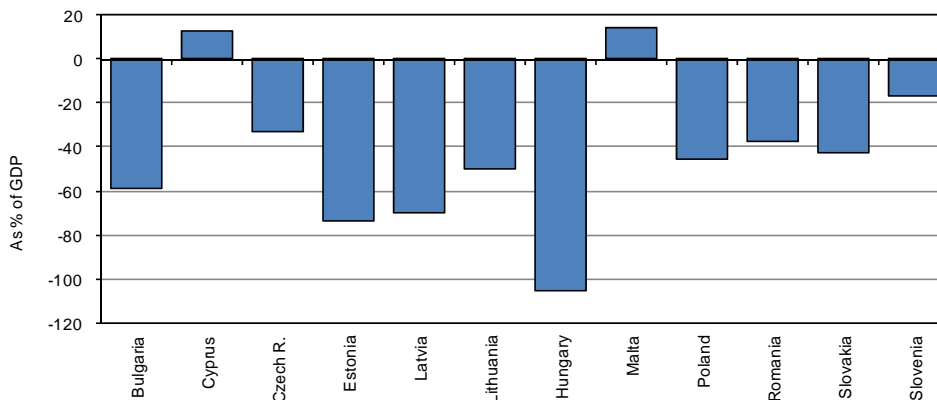


Source: Bank of Slovenia, calculations by IMAD

*Besides higher net interest payments, net paid return from equity capital within direct investments has also increased in the current account over recent years.*

In foreign direct investments in Slovenia after 2005, equity capital expenditure exceeds equity capital income. Capital gains were more volatile than paid return on liabilities and received return on international claims. Particularly outstanding was 2003, when the net loss of capital equity on foreign direct investments increased considerably.

Figure 37: International investment position of new Member States (at the end of 2006), in % GDP



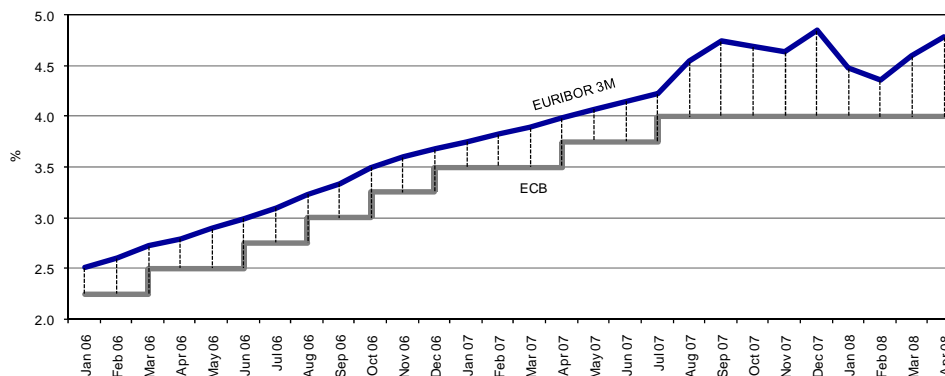
Source: SORS, Bank of Slovenia, Eurostat, calculations by IMAD

## 6. The financial crisis on international monetary markets in 2007 and assessment of its impact on the Slovenian economy

*The impact of the financial crisis, considering its magnitude, is also transferred to other segments of the economy, while the differences between countries are immense.* The crisis started in August 2007 with the breakdown of the subprime mortgage market in the US. Because of the nature of risk diffusion through the process of securitisation that has taken place in recent years, it quickly spread to the other parts of the world. The existing overall loss for banks and other financial institutions stands at somewhat over USD 300bn, while IMF estimates that the overall loss will exceed USD 900bn. Considering the magnitude of the crisis, consequences will be felt not only in the financial but also in the real estate sector, but the impact is considerably different among countries, as countries, including Slovenia, where modern financial instruments are less developed than in the US and older EU Member States are less directly exposed. Increased risk in these countries related to the consequences of the financial crisis has been assessed to be shown primarily in the case of closer ties with exposed banks abroad.

*The most obvious direct influence of the financial crisis was the aggravated situation on inter-bank markets, where interest rates, as a sign of less trust among banking subjects, have risen considerably.* The average margin between the 3-month EURIBOR and the key interest rate of the ECB from the beginning of the crisis until May 2008 stands at 0.64 percentage points, while it was at 0.26 in the first seven months of 2007. The ECB has not changed interest rates, which stand at 4.0%, since June 2007, while the 3-month EURIBOR increased from 4.2% in July 2007 to 4.9% this May.

Figure 38: ECB interest rates and 3-month EURIBOR



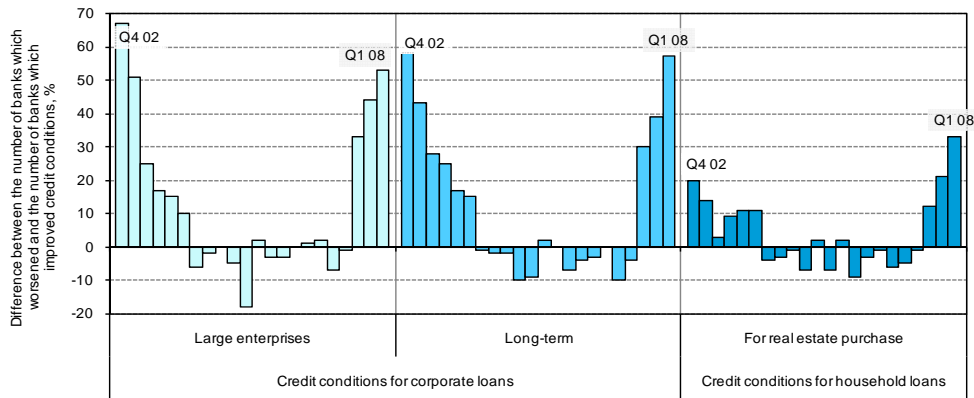
Source: ECB

*Aggravation is also shown by the indicator of monetary conditions in the Eurozone.* The ECFIN indicator of monetary conditions in the Eurozone, which is a combination of changes of real foreign exchange rates and short-term interest rates, has been growing rapidly since last August, which indicates more

restrictive monetary conditions. The value of the indicator dropped in the first two months of this year, but again increased considerably in March and April.

*The key channel of transfer of the financial crisis to the real economy is through worsening of loan conditions and reduced loan availability.* According to the results of the ECB Bank Lending Survey,<sup>20</sup> loan conditions in the Eurozone started worsening in the third quarter last year, and this trend has been growing ever since. The ECB assesses that loan conditions worsened more in terms of loans to companies than to households, and more for large companies than for small and medium-sized companies, and more for long-term than for short-term loans.

Figure 39: Changes in loan conditions between the last quarter of 2002 and the first quarter of 2008



Source: ECB

*The worsening of loan conditions has been increasing since the beginning of the financial crisis last August and is expected to continue in the following quarters.* The main reasons for banks in the Eurozone making their conditions for loans to companies stricter are more pessimistic expectations in terms of the general economic situation and banks' ability to access market financing. The tightening of loan conditions, judging by the response from banks, is already being reflected in decreased demand, primarily from large companies for long-term loans. In the April survey,<sup>21</sup> banks still estimated that the tightening of loan conditions, primarily for large companies and for long-term loans, will continue in the next three months, while the demand for loans will continue to decrease.

*The high growth in loans to companies continues despite the deterioration in loan conditions.* The growth in loans to companies and non-monetary financial institutions was higher last year than in 2006, which is the case for the Eurozone as well as the new EU Member States, including Slovenia; it increased slightly this year in all countries. Last year's growth at the Eurozone level stood at 13.9%, and at 32.2% in Slovenia (3 percentage points more than the average growth in

<sup>20</sup> ECB Bank Lending Survey (October 2007, January 2008, April 2008).

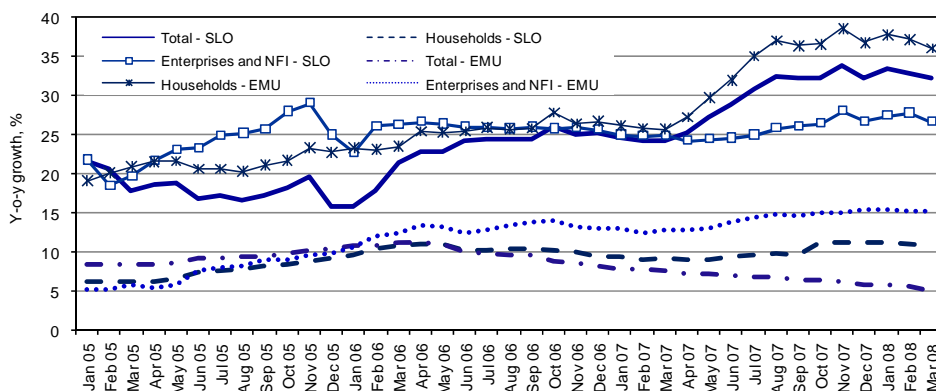
<sup>21</sup> ECB Bank Lending Survey (April 2008).

the new Member States). The continued high growth in loans to companies indicates on the one hand that companies are planning their investments despite the fact that global economic growth is slowing down. On the other hand, this may show that alternative financing sources (structured financial instruments) are less available because of the financial crisis, so that companies have no other choice than to take loans from banks<sup>22</sup>

*Similar to the situation with companies, loan conditions in the Eurozone countries also worsened in terms of loans to households, although to a lesser extent.* In terms of loans to households, loan conditions are becoming stricter for housing loans than for consumer loans. The main factors influencing the deterioration of loan conditions for the first type of loans are pessimism regarding the general economic situation and housing market prospects. When it comes to consumer loans, these are pessimistic expectations regarding the general economic situation and decreased creditworthiness of consumers. Similar to the situation with companies, banks are expecting further deterioration in loan conditions and less demand for loans, also in terms of loans to households, and both more intensively for housing loans than for consumer loans.

*The growth of loans to households in the Eurozone has been slowing since 2005 because of the higher interest rates of the ECB.* In the Eurozone, the growth of loans to households for the purchase of real estate started slowing down before the beginning of the financial crisis, primarily because of a gradual increase in the key interest rate of the ECB from December 2005 onwards, and also because of a cooling-off of real estate markets in certain countries. The growth in housing loans in the Eurozone in 2006 stood at 12.3%, and last year at 8.3%, while in the first three months of this year it was 6.4%. However, the growth in housing loans in Slovenia remains high, almost five times higher than in the Eurozone. In terms of consumer loans, the picture is rather similar to the situation with housing loans.

Figure 40: Year-on-year growth in loans in Slovenia and the Eurozone

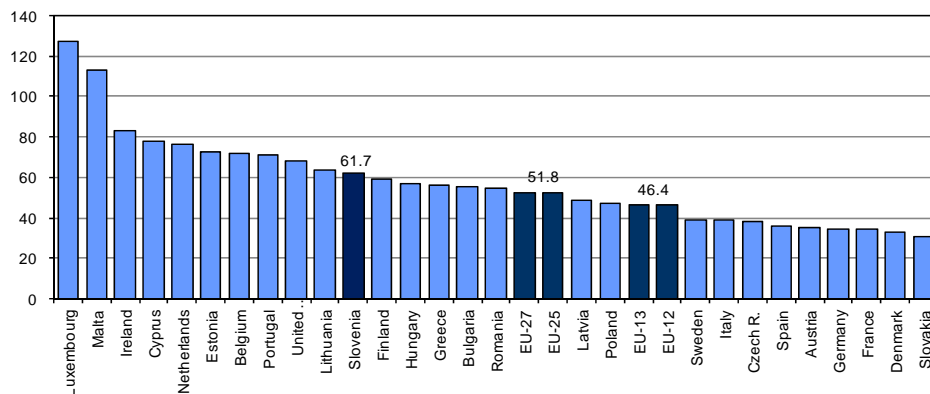


Source: ECB

<sup>22</sup> Citigroup mentions as one of the possible reasons for further high growth of loans despite deteriorating lending conditions also the fact that banks concluded lending agreements before the beginning of the financial crisis (estimated amount of USD 6,000bn), which companies did not start drawing until a few months ago.

*When identifying the possible consequences of the financial crisis for old and new EU Member States, exposure of their financial systems to foreign countries should be taken into account.* When the exposure to financial systems in foreign countries (a high share of foreign assets and liabilities in total assets of banks) is high, the effects of the financial crisis can be transferred faster and more intensively. An estimate of the exposure of financial systems to foreign countries on the basis of locational banking statistics of the *Bank of International Settlements*<sup>23</sup> indicates that Slovenia and its financial system, according to this indicator, were more exposed to foreign countries in 2006 than the EMU and EU averages. Only Malta, Cyprus, Estonia and Lithuania among the new EU Member States were more exposed to foreign countries.

Figure 41: Exposure to foreign countries as the share of overall total assets in country, 2006



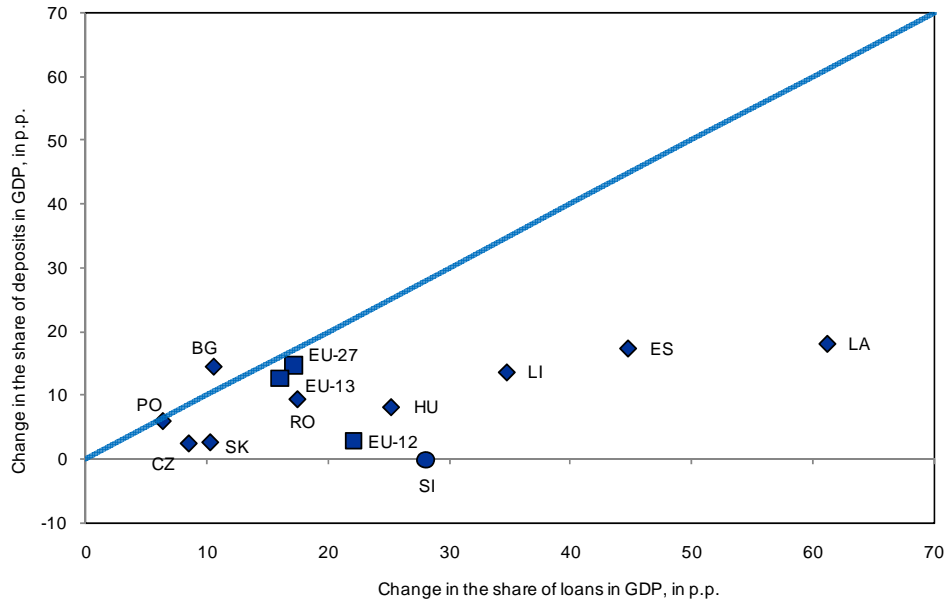
Source: ECB, BIS

*Banks in the majority of the new EU Member States satisfy needs for financing through taking loans abroad.* Dependence on foreign financing, which still does not necessarily mean greater effects of the financial crisis but increases related risks, can also be estimated on the basis of a comparison in the growth of the share of loans and deposits in GDP. Faster growth of the former signals increasing needs for financing, which banks cannot satisfy completely with deposits. This is a process characteristic of countries in the process of catching up with developed countries. As shown in Figure 42, the share of loans in GDP between 2002 and 2006 grew much faster in the majority of the new EU Member States, including Slovenia, than the share of deposits in GDP, while the growth of both shares at the Eurozone level as well as at the level of the entire EU is much more balanced.

<sup>23</sup> Banks which report to the Bank of International Settlements come from 40 countries, including EU members Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.



Figure 42: Change in the share of deposits and loans in GDP, 2002–2006



Source: ECB, Eurostat

## 7. Conclusion

Slovenia is decreasing the lag of its financial sector behind the average of the EU. Although the Slovenian financial system is mainly based on banks, the lag is most significant in the banking sector. In the area of bank loans to companies and non-monetary financial institutions, and consumer loans to households, Slovenia is relatively closer to the Eurozone average than in the area of housing loans, despite high growth in housing loans in recent years. The reasons can be found primarily in the insufficient development of the financial sector and shallowness of the domestic financial market, as other possibilities for financing are rather limited. The bigger gap in housing loans is primarily the consequence of less developed banking products in this area in the past, the privatisation of housing and its financing in the past, and an underdeveloped institutional framework, where gradual improvement has been seen only in recent years.

Decreasing interest rates in recent years have stimulated demand from companies and non-monetary financial institutions for loans, which in these years also increased due to favourable conditions in the international economic environment and certain structural changes in the economy which positively influenced domestic economic activity. High demand for bank loans in recent years is thus linked to the needs of the domestic non-banking sector (companies, non-monetary financial institutions, population) for financial assets for financing domestic investment in equipment and machinery, infrastructure and the construction of housing and other buildings, and also for other investment activities at home and abroad. From this aspect, high growth in bank loans is necessary for financing faster economic growth and is a constitutive part of the process of catching up with developed economies.

The process of Slovenia's integration in the European financial market resulted not only in accelerated growth in domestic bank loans to the non-banking sector, but also in structural changes in banks' financial sources. This significantly increased the importance of foreign sources, primarily of long-term loans from foreign banks. This is a consequence, on the one hand, of better availability of these sources because of lower interest rates and reduced exchange rate risk after Slovenia's accession to the EU and the EMU, and on the other hand, insufficient growth in household savings for financing fast-growing loans. Deposits of foreign banks are also an important source of financing. At the same time, lower interest rates and better integration of the Slovenian financial sector in international financial and capital flows also stimulated the growth of assets in mutual funds, which are becoming an increasingly important form of household savings outside the banking system. With worsening conditions on international monetary markets, household savings in banks this year are again becoming increasingly important for financing the lending activity of banks, and their growth is primarily stimulated by higher interest rates and more risk in investments in mutual funds.

Although competition in the Slovenian banking sector is increasing, certain trends indicate that it is still insufficient. In the area of interest rates, the gap between lending and deposit interest rates is relatively wider than the average in the Eurozone, primarily in transactions with households. We estimate that relatively low competition was also partially affected by conditions on the

domestic monetary market before the entry to the EMU, when domestic banks were not encouraged enough to develop new banking products because of the favourable possibilities for investing in monetary policy instruments.

The increased borrowing of domestic banks abroad led to the growth of gross external debt, which at the current level, from the aspect of solvency at the macroeconomic level, still does not present a serious macroeconomic problem, as this is mainly long-term external debt in euros in which there is no danger of a fluctuating exchange rate. The relatively high growth in gross external debt, the share of which in GDP in comparison to developed countries of the Eurozone is still relatively low, is primarily a consequence of better integration in international financial movements, and reflects the process of convergence to more developed financial and economic systems. Risks for the banking sector, because of more borrowing abroad, increased somewhat in the last year, when the share of short-term foreign debt increased in their total liabilities, while there were no similar changes in the maturity structure among claims because newly granted loans are still mainly long-term loans. From the macroeconomic point of view, the net debt or net financial position, which besides loans also includes other financial inflows and outflows, is primarily important for a stable international financial position. Although the situation has worsened in recent years, the net external debt and deficit of the net financial position in Slovenia are still relatively low.

The Slovenian banking sector is exposed to the influence of movements in international monetary markets through fluctuations of interest rates, and to a lesser extent through derivative financial instruments, which are still relatively underdeveloped in Slovenia. The consequences of the last year's financial crisis are shown in the Slovenian financial system primarily in increased interest rates and the reduced availability of foreign loans, which will also influence the availability of loans in domestic banks and the financing of domestic economic activity. Given less accessible external sources of financing, banks also resort to capital injections in order to acquire additional assets, which is a consequence of the fact that the capital adequacy of the majority of banks did not follow the high lending activity, while additional capital requirements are also imposed by the implementation of the Basel II Framework.

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***Challenges of the Labour Market  
from the Aspect of Flexicurity***



## Summary

In the 2000–2007 period, the unemployment rate decreased, standing at 4.9% in 2007. The unemployment rate in Slovenia decreased faster than the EU average and the averages of the old EU Member States. In this period, the long-term unemployment rate also decreased (in 2000: 4.1%, in 2007: 2.2%). However, the following problems in the area of unemployment remain: a high share of long-term unemployment, unemployment among young (15–24 years of age) and older people (over 50 years of age), and an increasing number of registered unemployed persons with a tertiary education.

In the 2000–2007 period, the number of persons in employment in Slovenia increased at an average annual rate of 1.4%, which was above the EU average. The employment rate (15–64 years) in Slovenia increased to 67.8%, which was above the EU average; the employment rate for women was above the EU average and below the EU average for men. The employment rates of younger (15–24 years) and older workers (55–64 years) remain relatively low. They represent an important share of "reserves", which is not high in the group aged between 25 and 54, to increase the employment rate in Slovenia. The share of temporary employment is growing rapidly and such employment among young people (15–24 years) is very widespread, which causes segmentation of the labour market and certain problems for the youth.

As a response to the challenges of globalisation, the concept of flexicurity was created in the EU, which also became Slovenia's objective with the revised Lisbon Strategy. The integrated concept of flexicurity consists of four components, which are combined to create a dynamic labour market and provide security to individuals: 1) flexible employment and contractual relationships (from the perspective of the employer and employee) through modern labour laws, collective agreements and work organisation; 2) active labour market policy, which effectively assists people in the case of unemployment and enables them to transition to new employment; 3) the system of lifelong learning, which provides employees with adaptability and employability; and 4) modern social security systems, which adequately combine the system of income support and incentives for work and labour market mobility.

Measurement of flexicurity is still developing, as this is a relatively new concept. The first analyses of flexicurity models (Phillips and Eamets, 2007) placed Slovenia among the group of countries with great challenges in the field of flexicurity. Slovenia ranked together with Poland, Hungary, the Czech Republic and Slovakia in a group characterised by modest mobility, high long-term unemployment, a low employment rate for older people (indicating modest labour market flexibility), high security of income and low social confidence. Challenges facing these countries are creating flexibility and ensuring income security. This chapter attempts to show and evaluate policies and measures in the field of creating flexicurity carried out in Slovenia over the past two years.

Also in respect of flexicurity, the main problems in the labour market are long-term unemployment and a low employment rate for older people, along with a modest rate of part-time employment. Since long-term unemployment decreases human capital, active labour market policy (ALMP) programmes which prevent

transitioning to long-term unemployment should be developed and strengthened from the aspect of flexicurity. Slovenia has one of the lowest employment rates for older persons in the EU. A low employment rate for older people, which is especially low for women, is a major challenge for economic and labour market policies. Within ALMP, it would be reasonable to strengthen programmes which stimulate employment of older persons, while changes in the pension system to encourage longer work activity are also necessary. The necessity of additional adaptation of the pension system to demographic changes is also indicated by the fact that the increase in the average retirement age after 2005 decelerated considerably and that the average retirement age in Slovenia is 1.4 years below the EU average. The share of part-time employment, which usually represents a "friendly" form of flexible labour, is still relatively low despite having increased recently. Part-time employment represents an opportunity for increasing flexibility and the employment rate.

A review of measures taken in the four key areas of flexicurity shows that the changes in the last two years were primarily directed toward better flexibility of contractual relationships. Amendments to the Employment Relationship Act (ERA) in 2007 were aimed at better internal flexibility (employment by type of work), possibilities for employment for a fixed period of time were expanded, and certain obstacles to employers' interest in part-time employment were also reduced. Amendments to the ERA aimed at providing better flexibility did not result in a substantial reduction of dismissal costs, which are in economic theory an important reason for employers' caution in the hiring process (the amount of severance pay is unchanged, with notice periods reduced only for certain groups of employees). We assessed that greater changes in this area were not possible because they were not supported with measures providing higher income security and measures for higher adaptability of employees (lifelong learning).

Active labour market policy, lifelong learning and social security systems in Slovenia still do not play an appropriate role in the creation of flexicurity. Active labour market policy must provide a quick and easy transition between jobs. Therefore, education and training programmes for the employed and unemployed should be strengthened in Slovenia. Participation of less skilled and older persons should be increased. In the area of education and training of employees, it would be reasonable, in addition to tenders for co-funding education and training of employees in companies undergoing restructuring and in promising activities carried out in the last two years, to create tenders for co-funding education and training in small companies. Despite the relatively high participation of adults (25–64 years) in lifelong learning in comparison with other countries, the inclusion of older persons and less educated persons is too low to contribute to the establishment of flexicurity. Previous amendments to the Social Assistance Act and Employment and Insurance Against Unemployment Act primarily increased commitments of unemployed persons in terms of acceptance of employment, while sufficient in-work benefits and means of keeping older people in employment were not created.

Creation of a flexicurity model remains a great challenge for Slovenia. Creation of flexicurity requires a more integrated approach to ensure mutual support and coordinated implementation of all four policies. Higher flexibility will not be possible without the support of other flexicurity policies, primarily: 1) provision



of greater participation of older and less trained people in lifelong learning; 2) effective active labour market policies, which would prevent transitioning to long-term unemployment and largely focus on the transition between jobs through adequate educational and training programmes for the employed; and 3) provision of income security, also in the case of unemployment.

## Introduction

*Discussion on the labour market is topical from the point of view of providing competitiveness and flexicurity and creation of flexicurity policies.* On the one hand, the labour market plays an important role in the competitiveness of the economy, where emphasis is placed primarily on the need to create a more flexible labour market. Flexibility of the labour market and primarily flexibility of wages in the EMU represent one of the important mechanisms to adjust the economy to external shocks.<sup>1</sup> Movement of labour costs is an important criterion to determine and stimulate competitiveness. On the other hand, an important goal of EU policies is also provision of social cohesion and social inclusion. Faced with these challenges, the EU has put long-term growth, which will ensure the growth of quality jobs, among the goals of the renewed Lisbon Strategy. For this purpose, the integrated guidelines for implementation of the Lisbon Strategy, among other things, envisage: measures to engage more people in employment and modernise social security systems, measures to improve the flexibility of employees and companies, and measures to increase investment in human capital and promote lifelong learning. At the EU level, the concept of flexicurity was created, arising from the complementary dimensions of flexibility and security.

*The topic (labour market) is presented in two sections.* The first section presents trends in the unemployment rate, employment rate, sectoral changes in employment, movement of wages and labour costs per production unit in the 2000–2007 period, and the prevalence of temporary and part-time employment. Although unemployment decreased and employment increased in this period, we emphasise certain problems in the labour market which have remained a challenge. In the second section, we present the concept of flexicurity and methods of measuring it, and attempt to give an overview of policy and measures taken in Slovenia over the last two years in the four basic areas of policies for providing flexicurity. In the final part, we endeavour to define the most important challenges of the labour market from the aspect of flexicurity.

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<sup>1</sup> At the macroeconomic level, different forms of flexibility of wages are important to adapt the economy to shocks. The following three forms of wage flexibility are emphasised most: 1) response to changes at the level of prices or inflation, which represents so-called nominal flexibility; 2) response to the unemployment rate, which measures how quickly the imbalance in the labour market is "resolved" and is labelled as real wage flexibility; 3) response to changes in the structure of supply and demand, which is labelled as relative wage flexibility and related to geographical and sectoral mobility and imbalances in labour markets.

## 1. Trends in the labour market in Slovenia in the 2000–2007 period

### 1.1. Unemployment rate

*The 2000–2007 period saw a reduction of the unemployment rate, which accelerated considerably in 2006 and 2007.* Acceleration of the reduction of the unemployment rate over the last two years could be linked to the considerable acceleration of economic growth recorded in 2006 (5.7%) and 2007 (6.1%).

Table 1: Unemployment rates in Slovenia by gender in the 2000–2007 period

	Overall	Men	Women	Gender gap (women-men)
2000	7.0	6.8	7.3	0.5
2001	6.4	5.9	7.0	1.1
2002	6.4	5.9	6.8	1.1
2003	6.7	6.4	7.1	0.7
2004	6.3	5.5	6.4	0.9
2005	6.5	6.1	7.1	1.0
2006	6.0	4.9	7.2	2.3
2007	4.9	4.0	5.9	1.9

Source: Statistical Office of the Republic of Slovenia (SORS), Statistical information, Labour Force Survey

*The unemployment rate for men decreased faster than that for women.* The unemployment gender gap had been increasing until 2006, indicating a deterioration of the relative position of women in the labour market. In 2007, this difference slightly decreased and the relative position of women somewhat improved (see Table 1). The gender unemployment gap decreased in the EU average in the 2000–2007 period. The increase in the unemployment gap in Slovenia points to the need for better inclusion of women in active employment policy programmes, which would improve their employability.

Table 2: Unemployment rates by age group

	15–24 years	25–49 years	50–64 years	Overall
2000	16.8	5.7	6.2	7.0
2001	18.1	5.1	4.8	6.4
2002	16.7	5.4	4.3	6.4
2003	17.4	5.9	4.3	6.7
2004	16.3	6.8	4.3	6.3
2005	16.0	5.9	4.4	6.5
2006	13.9	5.6	3.8	6.0
2007	10.3	4.4	4.1	4.9

Source: SORS, Statistical information, Labour Force Survey

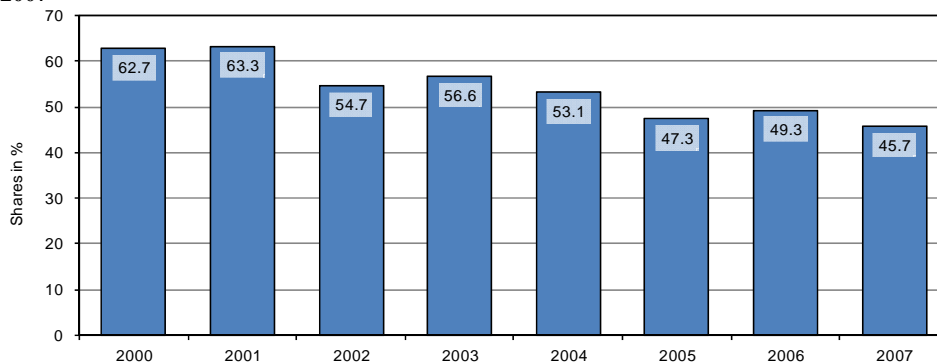
*In the 2000–2007 period, the unemployment rate for the age group between 15 and 24 years decreased the most (see Table 2).* The decrease was somewhat higher for women than for men. The fact that smaller generations of young people are entering the labour market also contributes to a decrease in the unemployment rate for young people. The youth unemployment rate is twice the unemployment rate for the entire population. The deviation of the youth unemployment rate from the average is also influenced by the low employment

rate of young people and high participation of young people in education. This is why the ratio between the number of unemployed young people and the total number of young people is a better indicator of the issue of unemployment among the youth. In 2006, this ratio stood at 5.6% and has been decreasing gradually since 2000 (6.4%). If this ratio is compared to that in the Netherlands, which records the lowest youth unemployment rate in the EU (5.9% in 2007), it can be seen that in 2006 in Slovenia it stood at 5.6%, while it was 4.6% in the Netherlands. Despite the decrease in the unemployment rate for young people, they still face difficulties when entering the labour market and are more exposed to flexible forms of employment than other age groups (see Section 1.3). Data on registered unemployment indicate that the average number of unemployed persons with a tertiary education in 2007 was 50% higher than in 2000, and their share in overall unemployment increased from 4.4% in 2000 to 10% in 2007.

***Long-term unemployment remains relatively high, even though it is decreasing.***

In the 2000–2007 period, the share of long-term unemployed persons<sup>2</sup> decreased, but in 2007 it was still relatively high (45.7%) and above the EU average (42.8%). From the aspect of flexicurity, this as a rule indicates modest mobility in the labour market and is also discussed in Section 2.1.2. Long-term unemployment decreases human capital and, consequently, the potential for new employment. Older and less educated people are more frequently exposed to long-term unemployment. The share of unemployed persons over 50 years of age in overall unemployment increased in the 2000–2007 period.

Figure 1: Share of long-term unemployed persons in overall unemployment in Slovenia, 2000–2007



Source: Eurostat

## 1.2. Employment rate

***The employment rate increased in the 2000–2007 period.*** The employment rate<sup>3</sup> for the population aged between 15 and 64 in 2007 was 5 p.p. higher than in 2000, whereas the employment rate for women increased by 4.2 p.p. and for men

<sup>2</sup> A long-term unemployed person is a person who has been unemployed for more than a year.

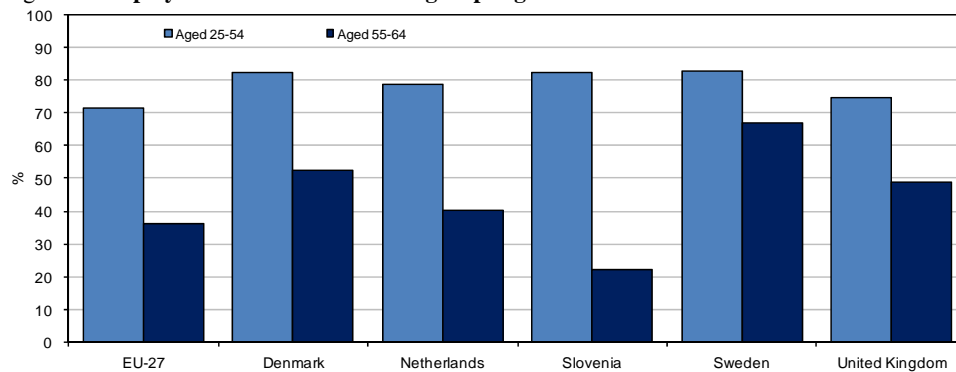
<sup>3</sup> Employment rate is calculated based on data from the Labour Force Survey.

by 5.5 p.p.<sup>4</sup> As shown in Table 3, the employment rate increased for all age groups. A faster increase in the employment rate came in 2004, when economic growth was also enhanced. In the 2000–2007 period, according to the labour force survey, the employment rate increased annually by 1.4% on average, which was faster than in the EU (1.1%). In 2007, Slovenia recorded a significant increase in employment,<sup>5</sup> which accompanied strong economic growth (6.1%). The employment rate for the population aged between 15 and 64 increased in 2007 to 67.8% and came close to the Lisbon objective (70%).<sup>6</sup>

**The employment rate in Slovenia has been exceeding the EU-27 average since 2004.** As early as in 2003, it was at the level of the EU-27 average (62.6%), and it considerably increased in 2004 and exceeded the EU average. In the 2004–2007 period, it increased in Slovenia and the EU by 2.5 percentage points and still exceeds the average of the EU-15 (66.9%) and EU-27 (65.4%).

**Regarding the employment rate for women, Slovenia has been exceeding the Lisbon Strategy objective (60%) since 2004.** The employment rate for women (aged 15–64) in 2007 stood at 62.6%. The employment rate for women in the group aged between 15 and 64 has been above the EU average for more than 10 years, but despite the increase the employment rate for older women remains exceptionally low. The employment rate for women in the group aged between 25 and 54 in Slovenia is comparable to that in Denmark, which records the highest employment rate for women in the group aged between 15 and 64 in the EU. However, in Slovenia the rate in the next age group (55–64 years) decreases the most among all EU Member States (see Figure 2). More details on the reasons for the low employment rate for older persons are available in Section 2.1.2.

Figure 2: Employment rate for women in groups aged between 25 and 54 and between 55 and 64



Source: Eurostat

<sup>4</sup> This is reflected in an increase in the difference between unemployment rates for men and women.

<sup>5</sup> The number of persons in employment according to the Labour Force Survey increased by 2.5%, the number of persons in formal employment increased by 3.5%, while employment according to national accounts statistics was higher in 2007 by 2.7%.

<sup>6</sup> In 2000 in Lisbon the employment objectives by 2010 were set to: 70% for the employment rate of the population aged 15–64 years, 60% for the employment rate of women and 50% for the employment rate of older workers 55–64 years old.

*The employment rate for men in Slovenia is behind the EU average.* The employment rate for men (aged between 15 and 64) increased in the 2000–2007 period by 5.5 percentage points and stood at 72.2% in 2007, which was below the EU average (72.5%). In this period, the employment rate for men increased more than the employment rate for women, but this sufficed only to reduce the margin between Slovenia and the EU average.

**Table 3: Employment rates by age group (in %)**

	15–24 years	25–49 years	50–64 years	55–64 years	15–64 years
2000	33.6	85.6	37.3	22.5	62.9
2001	31.4	86.6	41.1	25.0	63.9
2002	30.6	86.3	41.3	24.4	63.4
2003	29.3	85.5	41.1	23.5	62.6
2004	34.0	86.3	45.8	29.0	65.3
2005	34.1	86.3	47.3	30.5	65.9
2006	35.0	86.3	49.1	32.6	66.6
2007	37.6	87.6	49.5	33.4	67.8

Source: Eurostat

*The employment rate for young people in Slovenia increased in the 2000–2007 period, but it still represents reserves for an increase in the employment rate.*

The employment rate of young people (aged between 15 and 24) increased in the observed period and in 2007 slightly exceeded the EU-27 average (37.2%). "Reserves" for an increase in employment of young people are indicated by the fact that the employment rate for young people in Slovenia in 2007 was still 30.8 percentage points behind the employment rate for young people in the Netherlands, which has the highest employment rate and lowest unemployment rate. The employment rate for young people in Slovenia lags behind the average of the old 15 EU Member States (40.8%). The issue of reserves for an increase in the employment rate for youth in Slovenia has not been researched sufficiently. One of the reasons for the low rate in Slovenia in comparison to the EU-15 average is the high inclusion of youth in education, which generally improves possibilities for employment.<sup>7</sup>

*The employment rate for older workers is increasing, but is still very low.* As shown in Table 3, the employment rate for older persons has been growing rather rapidly since 2000. This is due to the effects of the 2000 pension reform,<sup>8</sup> as well as to demographic and statistical effects.<sup>9</sup> The employment rate for older persons (aged between 55 and 64), for which the Lisbon Strategy objective to attain 50% by 2010 was set in 2000, was still among the lowest in the EU in Slovenia, despite an increase of 11.2 percentage points in the 2000–2007 period.

*Slovenia has one of the lowest employment rates for older persons in the EU.* In 2007, only six countries in the EU had lower employment rates for older men and only two countries had lower employment rates for older women.<sup>10</sup> A low

<sup>7</sup> According to Eurostat, the inclusion of young people (15–24 years of age) in education in Slovenia in 2005 stood at 68.8%.

<sup>8</sup> The average age of new recipients of old-age pensions increased in the 2000–2007 period by 1 year and 6 months for men and by 2 years for women.

<sup>9</sup> A part of the early-retirement generation from the early 1990s falls within the group aged over 64, and their work activity is no longer measured in the Lisbon objectives.

<sup>10</sup> In 2007, Sweden had a three-times-higher employment rate for older women than Slovenia (22.2%).

employment rate for older persons, together with the population ageing process, increases pressure on the growth of public expenditure for pensions (see the chapter "Fiscal Development and Policy"). The employment rate for older persons is used in certain studies as an indicator of flexicurity and is therefore discussed in comparison with other countries in more detail in Section 2.1.2.

### 1.3. Prevalence of part-time and temporary employment

*The prevalence of part-time and temporary employment is frequently pointed to as a simple indicator of flexicurity.* Employment with shorter working hours (part-time employment) usually increases the flexibility of the labour market in terms of supply and demand. Part-time employment increases possibilities to adjust the scope of employment and reduce the costs of such adjustments. A proportionately high share of temporary employment in total employment is usually also the result of high dismissal costs or difficulties related to dismissals. Malenfant, LaRue and Vezina (2007) claim that the effects of intermittent work on well-being are as damaging as those of unemployment. Since flexibility is an important component of flexicurity, which is discussed in Section 2, we present here primarily the movement of shares of part-time and temporary employment in Slovenia in the 2000–2007 period. The share of part-time employment in total employment as an indicator of flexicurity in comparison to other EU Member States is discussed in Section 2.1.2.

*The share of part-time employment in total employment in Slovenia is increasing.* This could be interpreted as a trend directed to an increase in labour market flexibility. The increase in the share of part-time employment in Slovenia is largely the result of an increase in the number of such jobs among young people (aged between 15 and 24) and older persons (aged between 50 and 64). As far as young people are concerned, this is probably due to an increase in the scope of student work, which puts Slovenia above the EU average in terms of the share of part-time employment among young people (29.8%). When it comes to older persons, an important reason for the increase is an increase in the number of unpaid family workers. A higher increase in the use of part-time employment was recorded after 2003, which may be linked to accelerated economic growth and, in particular with women, also to the possibility to use the right to work with less working hours introduced by the Parental Protection and Social Benefit Act.

*Slovenia's share of part-time employment is well behind the EU average for women and almost level with the EU average for men.* In 2007, 8.1% of persons in employment aged between 15 and 64 in Slovenia were in part-time employment (EU average: 17.6%). The share of women in a part-time employment relationship in Slovenia (10%) was well behind the EU average (30.7%), while the share of men in a part-time employment relationship (6.5%) has almost caught up with the EU average (6.9%). In the Netherlands, where part-time employment is the most widespread, as many as 74.7% of women and 22.7% of men are in part-time employment. However, the share of part-time employment in Slovenia is higher than the EU average among young women (aged between 15 and 24) and stands at 40.8%, while the EU average is 34.5%. This may be attributed to work through student employment services in Slovenia. Since the rate of part-time employment is also an indicator of flexicurity, it is also discussed in Section 2.1.2.

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

	15–24 years	25–49 years	50–64 years	15–64 years
2000	13.4	3.3	10.0	5.3
2001	15.8	3.3	8.2	5.3
2002	17.6	3.5	8.9	5.8
2003	21.8	3.3	7.9	5.8
2004	29.1	4.4	12.0	8.3
2005	30.1	4.3	9.5	7.8
2006	29.8	4.3	10.4	8.0
2007	29.8	3.9	11.6	8.1

Source: Eurostat

*The share of temporary employment in Slovenia has been increasing rapidly, especially after 2003.* Because of the rapid growth in the share of temporary employment, Slovenia is improving its ranking among the EU Member States.<sup>11</sup> In 2007, the share of temporary employment stood at 18.4% (EU average: 14.5%). It more than doubled in the last ten years and grew particularly fast after 2003, when it increased by 4.9 percentage points. Since employment protection in permanent contracts was reduced in Slovenia in 2003 with the Labour Relationship Act, the increase in temporary employment could be linked primarily to the accelerated economic growth recorded after 2003.

Table 5: Share of temporary employment in total employment by age group, in %

	15–24 years	25–49 years	50–64 years	15–64 years
2000	43.2	9.5	6.6u	12.8
2001	51.0	9.3	5.4u	13.0
2002	52.9	10.8	6.0u	14.6
2003	53.0	10.2	4.4u	13.5
2004	63.1	13.6	7.7u	17.8
2005	62.5	13.5	6.3u	16.8
2006	64.8	13.1	6.5u	17.1
2007	68.3	14.0	6.7u	18.4

Source: Eurostat

Note: u - statistically unreliable data

*The share of temporary employment is especially high among the youth (aged between 15 and 24).* In the majority of countries, the share of temporary employment among young people is higher than among other employed persons. In terms of the temporary employment share among the youth, Slovenia ranked first among the EU Member States in the second quarter of 2007, with 66.5% of young persons in employment being in temporary employment (women: 76.1%, men: 60%). The high rate of temporary employment among the youth in Slovenia is, to a certain extent, due to the occasional work of young people through student employment services, which are in the current arrangement attractive for employers from the aspect of quick adjustment of the number of working hours and persons and from the aspect of lower taxation of work through student employment services in comparison with regular employment. A high rate of temporary employment among youth represents age segregation of the labour market. This means that young people are facing more uncertainty in terms of stability of employment, which can have an influence on important decisions in

<sup>11</sup> In terms of the share of part-time employment in total employment in the group aged between 15 and 64, Slovenia ranked 4<sup>th</sup> in the second quarter of 2007 (behind Spain, Poland and Portugal) and overtook Finland, which was ahead of Slovenia in 2006.



their lives, among other things on the decision to start a family. From the aspect of flexicurity, the problem lies in the strict conditions (eligibility criteria) for acquiring unemployment benefits. This makes it difficult for young people with frequent temporary employment to acquire unemployment allowances that would provide them with income security.

#### 1.4. Sectoral structure of employment

*Changes in the sectoral structure of employment in Slovenia follow the changes in developed European countries, but with a considerable margin.* Due to growing productivity in agriculture and manufacturing and the process of replacing internal services in production activities with the purchase of these services on the market (outsourcing), the shares of persons employed in agriculture and industry have been decreasing in the sectoral structure of employment in developed countries for quite a while, and the share of people employed in services has been increasing. This process is slower in Slovenia. Slovenia still has relatively high shares of the active population employed in agriculture and manufacturing, while the share of persons employed in service activities is relatively low in comparison to developed countries. Because of international comparability, we shall analyse primarily the Labour Force Survey data.<sup>12</sup>

*The share of persons in employment in the agricultural sector (agriculture, forestry, fisheries) continues to decrease in the majority of the EU Member States, and is maintained in Slovenia at a level of about 10%.* Agriculture is still an area of reserve work activity, primarily for older and less educated persons who would otherwise be unemployed. This is why Slovenia has also a high share of unpaid family workers among persons in employment, because of which the number of persons in employment fluctuates considerably from year to year, while on the other hand this provides for relatively low effective unemployment in Slovenia. The share of persons in employment in the agriculture sector in Slovenia remains relatively high in comparison to other EU Member States and the EU average, and stays almost unchanged (see Table 6), while it is decreasing more or less rapidly in other Member States. Among the 27 EU Member States, five had higher shares of persons in employment in the agriculture sector in 2007 than Slovenia: Lithuania, Portugal, Greece, Poland and Romania.

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<sup>12</sup> The labour market in Slovenia is monitored by three statistics, which differ in the scope of work activity categories. The internationally coordinated Labour Force Survey defines as persons in employment, in addition to persons in an employment relationship and self-employed persons, other persons who performed any type of work for payment, profit or family well-being in the reference week. The Statistical Office of the Republic of Slovenia (SORS) also publishes monthly data on the statistics of persons in formal employment (employees and self-employed persons). Sources for the data are the Statistical Register of Employment (SRDAP) and the estimate of the number of farmers, which is based on quarterly data from the Labour Force Survey. These statistics, unlike the Labour Force Survey, do not cover different informal forms of work, such as unpaid family members, working by job contract or working in the grey economy. Employment statistics according to the national accounts methodology are supposed to estimate the number of persons in employment in the full-time equivalent. This is based on the Statistical Register of Employment, dynamics of the number of farmers who pay social contributions, and statistically determined ratios between these categories and the number of other persons in employment by area of activity.

Table 6: Sectoral structure and dynamics of persons in employment, Slovenia and the EU, 2000–2007

	Structure of persons in employment, in %				Difference in structure, in percentage points		Average annual growth 2000–2007, in %	
	Slovenia		EU27		Slovenia-EU27		Slovenia	EU 27
	2000	2007	2000	2007	2000	2007		
A Agriculture, hunting, forestry	9.6	9.9	7.9	5.5	1.7	4.3	1.7	-3.8
B Fisheries	...	...	0.1	0.1	-	-	-	-3.0
C Mining	0.8	0.5	0.6	0.4	0.3	0.0	-6.7	-3.1
D Manufacturing	30.3	27.6	20.3	18.1	10.0	9.5	0.0	-0.4
E Electricity, gas and water supply	1.1	1.1	1.0	0.9	0.1	0.2	0.4	-0.2
F Construction	5.4	6.0	7.6	8.2	-2.2	-2.1	3.0	2.3
G Trade, vehicle maintenance	13.4	12.1	14.3	14.4	-0.9	-2.3	-0.1	1.2
H Catering	3.8	4.0	3.7	4.2	0.1	-0.2	2.0	3.0
I Transport, warehousing, communications	6.7	6.2	6.2	6.1	0.5	0.1	0.2	1.0
J Financial intermediation	2.4	2.5	3.1	3.0	-0.6	-0.5	1.5	0.8
K Real estate, rental, business services*	4.8	6.9	7.6	9.6	-2.7	-2.7	6.7	4.7
L Public administration and defence	6.0	5.6	7.2	7.1	-1.2	-1.5	0.4	1.1
M Education	6.4	7.7	6.6	6.9	-0.2	0.8	4.0	1.7
N Health and social security	5.2	5.7	8.7	9.5	-3.4	-3.8	2.7	2.6
O Other public, common and personal services.	3.9	4.1	4.4	4.6	-0.5	-0.6	2.0	1.9
P Private households	...	0.1	0.9	1.1	-	-1.0	-	5.1
Q Extra-territorial organisations	-	-	0.1	0.1	-	-	-	-0.2
Persons in employment by survey (overall)	100.0	100.0	100.0	100.0			1.4	1.1
Industry (C through E)	32.3	29.2	21.8	19.5	10.4	9.7	-0.1	-0.5
Overall services (G through Q)	52.7	54.9	62.6	66.7	-9.9	-11.8	2.5	2.1
- mainly market (G through K)	31.2	31.7	34.8	37.3	-3.6	-5.6	2.7	2.2
- mainly public (L through O)	21.5	23.1	26.8	28.2	-5.3	-5.1	2.4	1.9

Source: Eurostat, calculations by IMAD

***The share of persons in employment in industry (areas of activity C through E) is still decreasing slowly, and in construction it fluctuates around 6%.***

According to the Labour Force Survey, the share of persons in employment in industry decreased in the 2000–2007 period from 32.3% to 29.2%, with the share in manufacturing dropping from 30.7% to 27.6%. It also continues to decrease in mining, where the number of persons in employment drops every year due to closure of mines, while the share in electricity, gas and water supply remains more or less unchanged.<sup>13</sup> The number of employees in construction has been increasing in recent years because of increased investment in construction, but this is not covered by the Labour Force Survey because of the increased seasonal employment of foreigners.<sup>14</sup> The share of employees in construction remains more or less unchanged after its increase in 2001 to around 6%.

<sup>13</sup> Similar movements are also indicated by the data from the national accounts statistics and from the Statistical Register of Employment.

<sup>14</sup> The Labour Force Survey does not cover foreigners with temporary residence in Slovenia, and thus this survey underestimates the number and share of persons employed in construction.

***Until 2005, Slovenia recorded the highest share of persons in employment in manufacturing in the EU, while the share of persons in employment in construction is below the EU average.*** Until 2005, the share of persons in employment in manufacturing exceeded the EU-27 average by more than 10 percentage points. In 2006 and 2007, this difference decreased, and the Czech Republic now exceeds Slovenia in relation to the share of all persons employed in manufacturing. The share of persons employed in construction is, according to the Labour Force Survey, among the lowest in the EU and about 2 percentage points below the EU-27 average.

***The share of persons in employment in service activities in Slovenia is still considerably lower than in the majority of European countries and is slowly increasing.*** According to the Labour Force Survey from 2000, the share stood at 51.9% and increased to 54.9% by 2007. Persons in employment in mainly public services<sup>15</sup> represent 23.1%, while persons in employment in mainly market services<sup>16</sup> represent 31.7%. Among the EU-27 Member States, only Romania and Poland<sup>17</sup> have lower shares of persons in employment in services than Slovenia. The EU-27 average is 66.7% (4.1 percentage points more than in 2000), while the EU-15 average is 70.2% (3.5 percentage points more than in 2000). Countries with the highest shares of employment in services (more than 75% in 2007) are Luxembourg,<sup>18</sup> the Netherlands, the United Kingdom and Sweden.

***Among service activities, trade has the highest share of employees in Slovenia, while the highest growth of employment is observed in business services, education, and healthcare and social work.*** In the 2000–2007 period, the share of persons employed in business services increased the most, both in Slovenia and in the EU. This represents the second largest area of employment (after trade) in the EU-27 average, while in Slovenia, according to the Labour Force Survey, there are still a larger number of persons employed in the area of education.<sup>19</sup> In terms of the shares of persons in employment in individual areas of service activities, Slovenia has a higher share than the EU-27 average only in the area of education and records the widest gap with the EU-27 average in the areas of health and social work,<sup>20</sup> business services and trade.

<sup>15</sup> In areas of activity L through O according to NACE-Rev 01.

<sup>16</sup> In areas of activity G through K according to NACE-Rev 01.

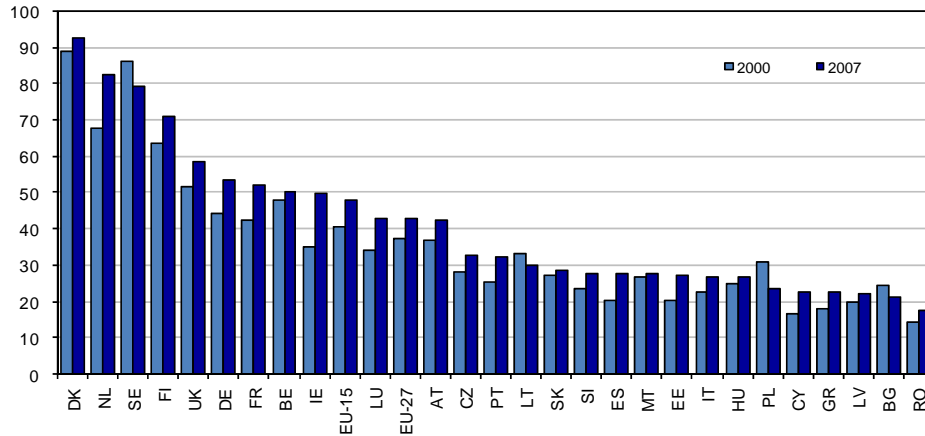
<sup>17</sup> In Poland, this share is somewhat lower than in Slovenia. In Romania it was 39.1% in 2007, while in 2000 it stood at 29.0%.

<sup>18</sup> 81.4% in 2007 and 76.6% in 2000.

<sup>19</sup> In the area of education, the Labour Force Survey in Slovenia, which also covers persons working outside of an employment relationship, systematically indicates a higher number of persons in employment than the Statistical Register of Employment, which covers only persons in an employment relationship. This difference, which stood at about 7,000 in 2000, increased by 2007 to about 15,000. These are primarily students or retired persons who work in the area of education outside of an employment relationship, and the increase is primarily due to a greater number of students, which increased in the observed period by 24,000 (from 91,494 in 2000 to 115,445 in 2007).

<sup>20</sup> In terms of the number of persons in employment in health and social work per 1,000 citizens, in 2007 Slovenia was in 15<sup>th</sup> place (see figure 3) among the 27 EU Member States.

Figure 3: Number of persons in employment in health and social work according to labour force surveys per 1,000 citizens, in the EU-27 in 2000 and 2007



Source: Eurostat, Population and social conditions, labour market, acquired at: <http://epp.eurostat.ec.europa.eu/portal/>

## 1.5. Wages, productivity and labour costs

### 1.5.1. Wage and productivity developments

**The relationship between wages and labour productivity is important for wage policy making.** In the implementation of economic policy goals, wage policy has become even more important with Slovenia's entry into the EMU and loss of independent monetary policy. In the area of wage policy, a guideline on the growth of real gross wage lagging behind the growth of real productivity by at least one percentage point was implemented in the previous period. The Social Agreement for 2007–2009 envisages that the growth of wages with regard to inflation and productivity in the private sector can be agreed in collective agreements for activities in the Collective Agreement on the Wage Adjustment Method, Reimbursement of Work-related Expenses and Holiday Bonus, and collective agreements of companies. The public finance framework should also be taken into account when determining wages in the public sector. A growth of wages that ensures price stability and is consistent with the trend in productivity growth is also recommended by one of the integrated guidelines for implementation of the Lisbon Strategy.

**Table 7: Nominal growth of labour productivity and gross wage per employee in the private and public sectors in the 2000–2007 period**

Year	Labour productivity	Gross wage per employee		
		Overall	Private sector	Public sector
2000	9.3	10.6	10.3	11.2
2001	11.5	11.9	10.9	13.9
2002	11.7	9.7	10.0	8.7
2003	9.0	7.5	7.8	6.7
2004	7.6	5.7	6.8	2.8
2005	5.7	4.8	5.4	3.4
2006	6.5	4.8	5.4	3.5
2007	7.3	5.9	6.9	4.1
2000–2007	8.6	7.6	7.9	6.8

Source: SORS, calculations for labour productivity by IMAD (Spring Forecast 2008)

Note: The gross wage per employee is calculated for the private sector (A to K) and public sector (L to O) according to the Standard Classification of Activities (SKD) by IMAD.

*Average annual growth in wages in the 2000–2007 period lagged behind the growth in labour productivity, except in 2000 and 2001.* As shown in Table 7, the average annual growth of wages in the 2000–2007 period amounted to 7.6%, while the growth of productivity was 8.6%. In 2000 and 2001, the nominal average gross wage per employee exceeded the growth of labour productivity. This was also the case for wage trends in the public sector in both years, while in the private sector the gross wage exceeded labour productivity only in 2000. The 2002–2007 period was characterised by a wider gap between the growth of wages in the public sector and labour productivity (3.1 percentage points) than in the private sector (0.9 percentage points). There are two reasons for decelerated growth of wages in the public sector: 1) implementation of the Salary System in the Public Sector Act, which prevented wage rises by introducing allowances from collective agreements; and 2) an adjustment mechanism which allocated part of the adjustment percentage to the elimination of wage disparities.

*The growth of wages lagging behind the growth of labour productivity by activity and by group of activity is not as clear as at the global level.* The relationship between the growth of wages and productivity by activity is only shown for the private sector. Productivity for the public sector is calculated statistically, but its measurability is difficult to assess. In 2000 and 2001, wages in the majority of activities of the private sector did not lag behind labour productivity; in the following period, this was only the case in one or two activities. In the 2000–2006 period on average, the growth of wages exceeded the growth of productivity in construction and the business services group of activities (J, K). In the 2002–2006 period, the growth of wages exceeded productivity only in the activities of real estate, renting and business services.

Table 8: **Nominal growth of labour productivity and gross wages per employee by activity and group of activities in the private sector**

	2000–2006		2002–2006	
	Productivity	Wages	Productivity	Wages
Overall	8.7	7.8	8.1	6.5
<b>Private sector (A through K)</b>	9.3	8.1	8.7	7.1
A Agriculture, hunting, forestry	7.2	6.0	6.2	5.6
B Fisheries	8.7	6.5	10.3	6.8
<b>Industry (C, D, E)</b>	9.7	8.5	8.6	7.4
C Mining	12.4	9.4	14.1	7.9
D Manufacturing	9.3	8.4	8.3	7.3
E Electricity, gas and water supply	12.3	9.5	9.3	8.6
<b>F Construction</b>	7.0	7.4	9.3	7.1
<b>Production services (G, H, I)</b>	9.4	7.2	8.8	6.5
G Trade, vehicle maintenance	9.3	7.1	8.8	6.7
H Catering	7.5	6.5	7.8	5.5
I Transport, warehousing, communications	9.7	7.8	9.3	6.4
<b>Business services (J, K)</b>	6.3	7.7	6.1	6.3
J Financial intermediation	8.0	8.4	8.5	7.5
K Real estate, renting, business services	3.4	7.8	1.9	6.2

Source: SORS, calculations by IMAD

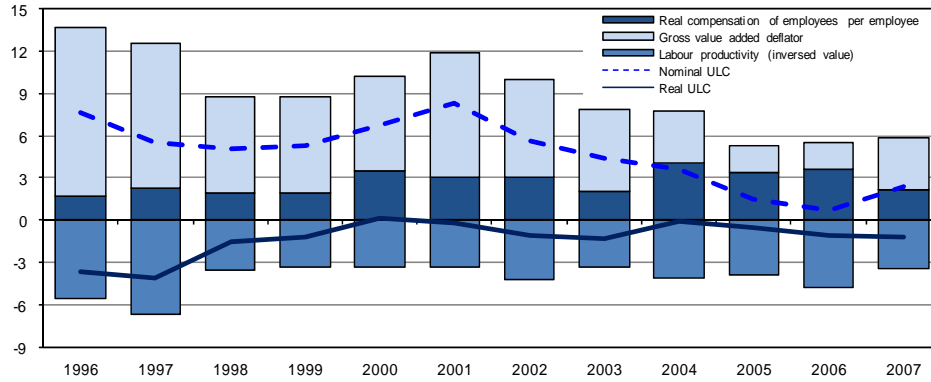
### 1.5.2. Unit labour costs

*In the 2001–2007 period, real unit labour costs in the Slovenian economy decreased more or less continuously together with considerable and gradual slowing of their nominal growth.*<sup>21</sup> After a rapid decline in the second half of the 1990s (annually on average by -2.6%), their real decrease also slowed in the 2001–2007 period (to -0.8%). Real growth of compensation per employee<sup>22</sup> somewhat recovered (from 2% in the second half of 1990s to 3.1%), while labour productivity settled at a still high level (3.8% vs. 4.7%; see Figure 4). With accelerated growth of gross value added, the recent years also recorded a notable growth of employment, which was still decreasing considerably in the mid-1990s.

<sup>21</sup> **Nominal unit labour costs** are defined as the ratio between nominal compensation of employees per employee and real gross value added per employee. **Real unit labour costs** are equal to nominal costs deflated by the implicit gross value added deflator. As the implicit gross value added deflators from the numerator and denominator cancel each other out, they are also defined as the ratio between the nominal compensation of employees per employee and nominal gross value added per employee.

<sup>22</sup> Deflated by the deflator of gross value added.

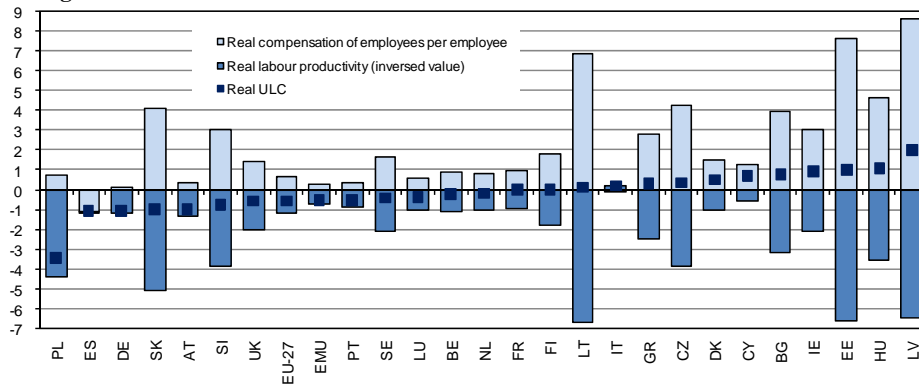
Figure 4: Nominal and real unit labour costs in the Slovenian economy, annual growth rates in %



Source: SORS, calculations by IMAD

*In comparison with the EU-27 (-0.6%) and the Eurozone (-0.5%), the drop of real unit labour costs in the Slovenian economy was slightly higher.* With relatively small differences in trends,<sup>23</sup> Slovenia was among the countries with a higher drop in the 2001–2007 period. Due to the catching-up process, Slovenia, Slovakia and Poland realised their relatively favourable positions in the conditions of exceptionally high labour productivity growth, while the relatively more favourable position of Germany, Austria and Spain is primarily the result of average growth or even drops in the compensation of employees per employee (see Figure 5).

Figure 5: Real unit labour costs in the EU Member States in the 2001–2007 period, average annual growth rates in %



Source: SORS, calculations by IMAD

Note: Compensation of employees per employee in real terms is deflated by the deflator of gross value added.

<sup>23</sup> The countries that stand out are Poland with the most distinctive drop and Latvia with the most distinctive growth.

*The sectors of the Slovenian economy which contributed the most to the relatively favourable trends in the 2001–2006 period were trade, catering, transport and industry (see Table 9).* The first three areas stood out because of the relatively modest real growth of the compensation of employees per employee, and the last area because of notable labour productivity growth. In business services and construction, where real growth of the compensation of employees per employee overtook relatively modest labour productivity growth, real unit labour costs increased. Conversely, modest real growth of the compensation of employees per employee in public services followed modest growth in labour productivity.

Table 9: Unit labour costs and components by sector of the Slovenian economy in the 2001-2006 period, average annual growth rates in %

Sector	Unit labour costs		Compensation of employees per employee		Labour productivity*
	Nominal	Real	Nominal	Real*	
Economy	3.9	-0.7	8.0	3.2	3.9
Economy without agriculture (without A, B)	4.0	-0.5	8.0	3.4	3.8
Agriculture and fisheries (A, B)	3.7	0.3	6.9	3.4	3.0
Industry (C, D, E)	1.8	-0.9	8.3	5.5	6.4
Construction (F)	6.1	0.6	9.2	3.6	2.9
Trade, catering and transport (G, H, I)	4.2	-1.2	8.3	2.7	4.0
Business services (J, K)	5.9	1.1	7.6	2.8	1.6
Public services (L through P)	5.4	-0.4	6.6	0.8	1.2

Source: SORS, calculations by IMAD  
Note: \*Deflated by deflator of gross added value.

*With a constant gradual reduction of differences, Slovenia still ranks considerably above the Eurozone average (62.5%) and also above the EU-27 average (64.7%) with its ratio between labour costs and gross value added in 2007 (70.3%).*<sup>24</sup> Among the EU Member States, Slovenia was closely followed by Romania (69.9%) and Portugal (69.5%), and to a lesser extent by Denmark (68.1%), while the differences in comparison to other countries were more noticeable. There are more reasons for the deviations, including the specificity of the Slovenian agriculture sector (with a large number of small farms and a large share of self-employed persons), differences in the structure of the Slovenian economy (primarily a smaller share of gross value added of financial intermediation, real estate and business sector, and a greater share in the industry sector), and higher taxation of work in Slovenia, which increases the ratio between labour costs and gross value added in the Slovenian economy. With a reduction in taxation of work, shown in the estimates for 2006 and 2007 because of the first effects of changes to income tax and gradual phasing out of payroll tax, measures to increase added value<sup>25</sup> will also have to be taken, in addition to the sustainable growth of labour costs per employee, in order to ensure the competitiveness of the Slovenian economy.

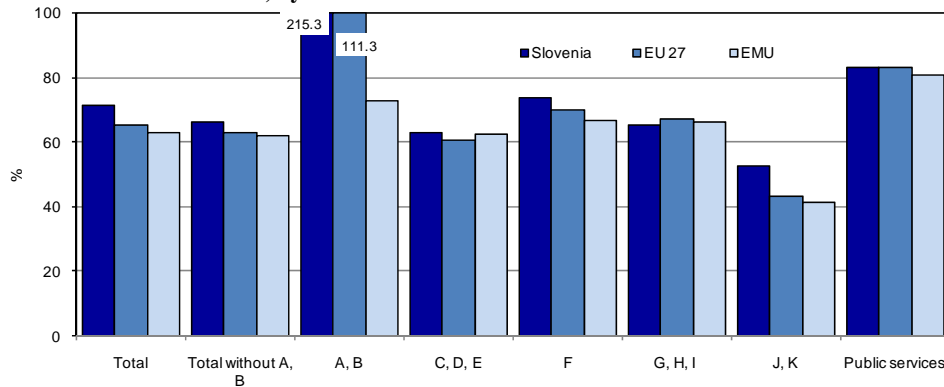
<sup>24</sup> Belgium (67.1%), United Kingdom (67.1%), Sweden 65.3%), Netherlands (65%), Hungary (64.5%), France (63.8%), Cyprus and Greece (63.1%), Latvia (62.4%), Austria (62.1%), and at the end Lithuania (55.9%), Poland (55.4%), Luxembourg (54.5%) and Slovakia (46.6%).

<sup>25</sup> For more details, see Economic Issues (2007): Wages, productivity and competitiveness.



*In 2006, the ratio between labour costs and gross value added in comparison to the EU and Eurozone average was the least favourable in business services and construction.* The differences further increased in recent years, especially in business services. Industry and public services came close to the EU and Eurozone average in terms of the ratio between labour costs and gross value added, while in trade, catering and transport this ratio was somewhat lower (see Figure 6).

Figure 6: Ratios between labour costs and gross value added (wage share) in Slovenia, EU 27 and the Eurozone in 2006, by sector



Source: SORS, calculations by IMAD

## 2. Flexicurity – concept, measurement, challenges

*The concept of flexicurity arises from the idea that security and flexibility do not exclude but rather complement each other.* Wilthagen and Tros (2004) define flexicurity as a policy and strategy that attempts to enhance the flexibility of labour markets, work organisation and employment relations, while improving employment security and social security. They provide the following definitions of flexicurity: 1) a degree of job, employment, income and combination security that facilitates the labour market careers of workers with a relatively weak position and allows for enduring and high-quality labour market participation and social inclusion, while at the same time providing 2) a degree of numerical,<sup>26</sup> functional and wage flexibility that allows for labour markets' and individual companies' timely and adequate adaptation to changing conditions in order to maintain competitiveness and productivity.

*A frequently used synonym for flexicurity is the Danish model.* The Danish labour market developments in the 1990s are frequently considered as a model of a dynamic labour market which considerably decreased the unemployment rate. Denmark implements a successful combination of a dynamic labour market and a relatively high level of social security. Its welfare model is characterised by a successful combination of labour market flexibility (great employment mobility as a result of relatively low employment protection), social security (generous system of insurance against unemployment) and active labour market policy. Active involvement of social partners is also important for the success of the Danish model.

*The concept of flexicurity is also included in the renewed Lisbon Strategy.* In 2007, the European Commission defined the concept of flexicurity from the aspect of creating adequate policies. The concept of flexicurity integrated in this definition consists of four components which are combined to create a dynamic labour market and provide security to individuals: 1) flexible employment and contractual relationships (from employer and employee perspectives) based on modern labour legislation; 2) active labour market policy, which effectively assists people in the case of unemployment and facilitates transitioning to new employment; 3) the system of lifelong learning, which provides continual adaptability and employability of workers; and 4) modern social security systems, which adequately combine the system of income support and incentives for employment and mobility in the labour market. The active participation of all social partners is a condition to create flexicurity which would be beneficial to all.<sup>27</sup>

### 2.1. Measurement of flexicurity

*There is still no consensus on indicators for measuring flexicurity, since the concept of flexicurity is relatively new and comprehensive.* Several attempts at

<sup>26</sup> Numerical flexibility denotes adjusting of the number of employees or working hours. For more detailed definitions of the term "market flexibility" see Kajzer (2005).

<sup>27</sup> EC (2007): Towards Common Principles of Flexicurity: more and better jobs through flexibility and security, Towards Common Principles of Flexicurity – Council Conclusions, 6 December 2007.

measurement and comparative analysis on the basis of different indicators have been made. Tangian (2004) derived the flexicurity index from the following criteria: criteria of employment protection and social security by legal basis, and data on trends of certain forms of employment (permanent, temporary and part-time employment, self-employment). His analysis includes 16 countries, without Slovenia.<sup>28</sup> A more recent analysis of flexicurity models (Phillips and Eamets 2007),<sup>29</sup> which is presented below, does include Slovenia.

***A more recent analysis of the flexicurity models that we present was made by Phillips and Eamets (2007).*** This is a factor analysis and cluster analysis of flexicurity indicators for 25 EU countries.<sup>30</sup> The analysis implemented 16 variables classified into the following groups: 1) *labour market flexibility criteria* – Eurobarometer indicators concerning the ease of finding a new job, e-workers and worker mobility, which are related to other indicators used: participation in training programmes, part-time employment, unemployment rate, youth unemployment, long-term unemployment and the employment rate of older people; 2) *social security* – two indicators of social protection expenditure (in % of GDP and per employee and purchasing power standards) and insurance against unemployment and duration of employment were included; 3) *social inclusion criteria* – the at-risk-of-poverty rate and Gini coefficient as a measure for distribution of income and the share of early school leavers (18–24 years) were included.

***The analysis identified 6 groups.*** The first group includes Austria, Belgium, France and Luxembourg, and represents a continental model of social and economic activity. In these countries, social protection is relatively high and the duration of employment at one employer is relatively long, which indicates low mobility and rigidity of the labour market. The second group consists of the Netherlands and United Kingdom, which are characterised by fairly liberal and flexible labour markets, a low unemployment rate, a high share of part-time employment and high labour mobility. The third group is represented by the Nordic countries – Denmark, Finland and Sweden, which are often used as benchmarking models in flexicurity debates and which record the highest values for the included variables. The fourth group features the Baltic countries (Latvia, Lithuania and Estonia), Ireland and Cyprus, where indicators of labour market flexibility are relatively high, while social and income security are relatively modest. The fifth group consists of Greece, Italy, Malta and Spain. They are labelled as the South European or Mediterranean group, which is characterised by modest labour market flexibility, low income security, a high unemployment rate and low inclusion of adults in lifelong learning. The sixth group consists of the Czech Republic, Hungary, Poland, Slovakia and Slovenia with the following common characteristics: modest mobility, high long-term unemployment and a low rate of work activity among older people. These results indicate low labour market adaptability.

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<sup>28</sup> The highest indices of flexicurity, according to this method, were recorded in Sweden, while Denmark ranks 6<sup>th</sup>.

<sup>29</sup> The study was carried out for the European Foundation for Improvement of Living and Working Conditions.

<sup>30</sup> The analysis includes data up to 2005.

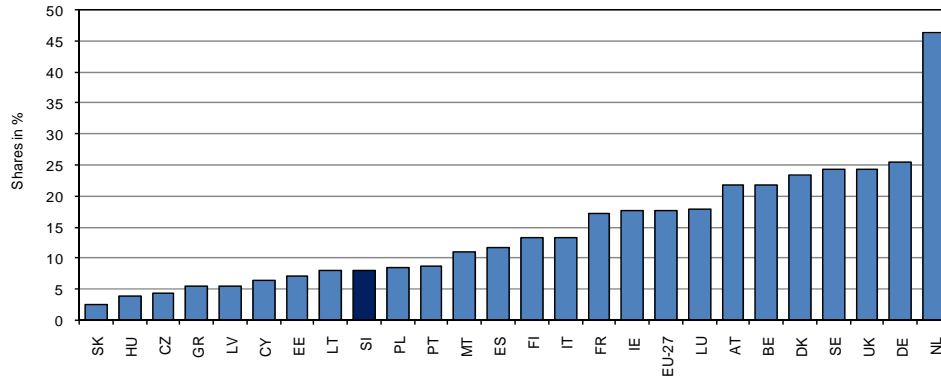
### ***2.1.2. Position of Slovenia according to certain flexicurity indicators***

***Out of 16 variables included in the above analysis, we present the position of Slovenia in the EU for indicators for which data from Eurostat is available.***

Among flexibility indicators, we present the share of part-time employment, long-term unemployment, lifelong learning participation and employment rate of older workers. Among social protection indicators, we present expenditure on social protection in PPS per capita, and among social inclusion indicators we present the at-risk-of-poverty rate and the share of adolescents who dropped out of school. In continuation, we will try to show Slovenia's position within the EU and (non)homogeneity of the sixth group, into which Slovenia was classified according to the study by Phillips and Eamets (2007).

***Slovenia ranks among those countries with a low share of part-time employment.*** As shown in Section 1.3, the prevalence of part-time employment in Slovenia increased in the last few years, but was still relatively modest (8.1%) and below the EU-27 average (17.6%) in 2007. In terms of the share of part-time employment, Slovenia is very far behind the Nordic countries, which usually represent the benchmark model of flexicurity. The sixth group, in terms of the part-time employment rate indicator, is relatively homogenous, since the Czech Republic, Hungary, Slovakia, Poland and Slovenia rank among the countries with a modest rate of part-time employment. The share of part-time employment in the EU average is more than double that in Slovenia. The highest prevalence of part-time employment is observed in the Netherlands, which has been encouraging part-time employment since 1982, after an agreement among social partners on the promotion of part-time employment as a form of labour that enables flexibility of supply and demand. In 2007, 46.3% of all employed persons aged between 15 and 64 in the Netherlands were employed in this manner (see Figure 7). The share of part-time employment, which usually represents a "friendly" form of flexible labour, is increasing in Slovenia but still remains relatively low (see Section 1.3). Part-time employment represents opportunities to increase flexibility and the employment rate in Slovenia. We estimate that the main reasons for its low prevalence in Slovenia are primarily: 1) modest interest from employers, for whom employing more persons part-time, despite last year's amendments to the Employment Relationship Act, is still more expensive than employing one person full-time, and 2) modest interest from employees because of the low income level provided by such employment.

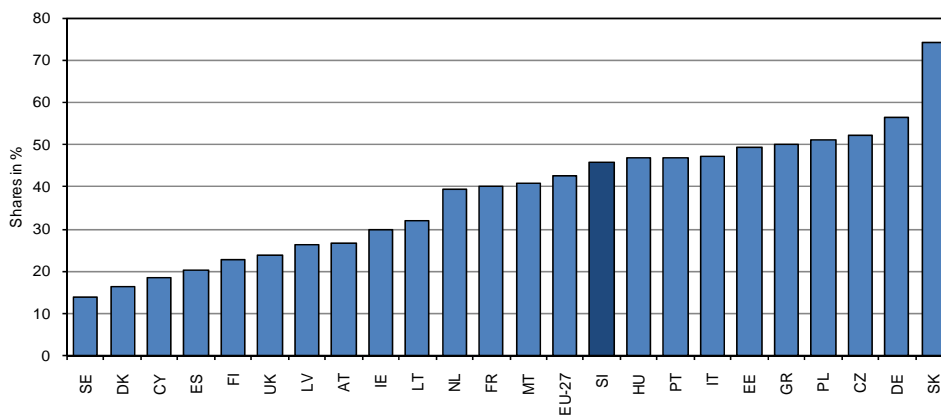
Figure 7: Share of part-time employment in total employment in the EU, in %, 2007



Source: Eurostat

*The share of long-term unemployed persons in Slovenia is relatively high.* The share of long-term unemployed persons could be an indicator of mobility in the labour market and flexicurity. Higher shares of long-term unemployed in total unemployment mean that the unemployed remain unemployed for a long time and that in countries with lower shares of long-term unemployed persons mobility in the labour market is higher than in countries with higher shares. As shown in Section 1.1, the share of long-term unemployed persons in Slovenia in the 2000–2007 period decreased but remains above the EU-27 average and is still relatively high. From the aspect of flexicurity, it would be reasonable within active employment policy, as shown in Section 2.2.2, to strengthen education and training programmes, which could reduce long-term unemployment and prevent transitioning into long-term unemployment. The sixth group, in terms of the long-term unemployment indicator, is relatively homogenous. Slovenia has almost a three times higher share of long-term unemployment than the Nordic countries group, which are usually the benchmarking model of flexicurity. A high share of long-term unemployed persons in Slovenia indicates the existence of imbalances in the labour market, the elimination of which requires active labour market and education policy.

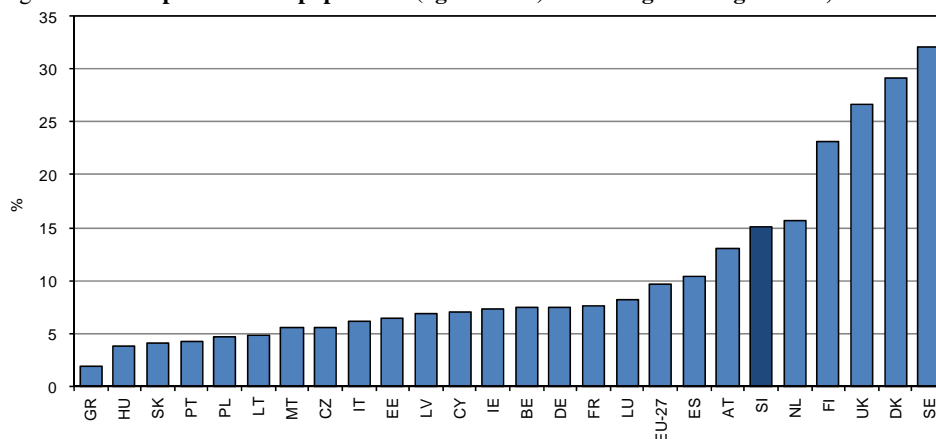
Figure 8: Shares of long-term unemployed in total unemployment in the EU, in %, 2007



Source: Eurostat

*Participation in lifelong learning in Slovenia is high.* Inclusion in lifelong learning improves possibilities for staying in employment. In terms of participation of adults in lifelong learning, Slovenia places high above the other countries in the sixth group and ranks immediately after the Nordic countries, the United Kingdom and the Netherlands (see Figure 9). But this favourable result for the average conceals the large difference between the inclusion of the middle and older generations and the inclusion of more and less educated persons, which is discussed in Section 2.2.3. Lower inclusion of older persons in lifelong learning also contributes to an early exit from the labour market, which is reflected in a low rate of employment of older people (55–64 years), where Slovenia is again ranked among the countries with the lowest rates and the countries of the aforementioned sixth group.

Figure 9: Participation of the population (aged 25–64) in lifelong learning in 2006, in %

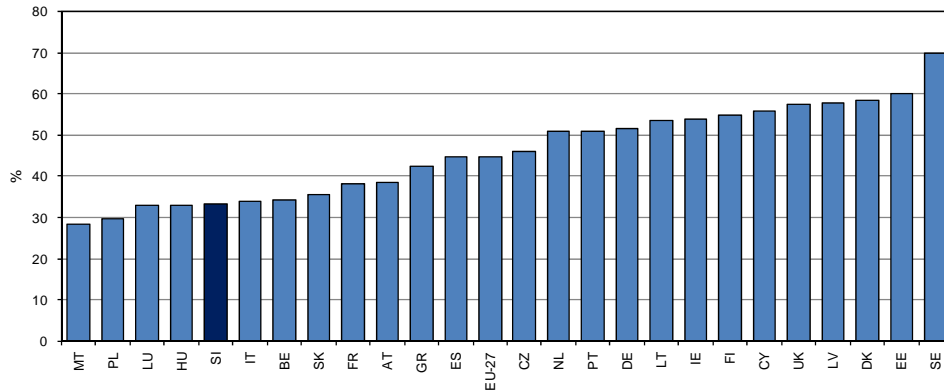


Source: Eurostat

*Slovenia ranks among the countries with the lowest employment rates of older workers.* Lifelong learning has an important influence on an individual's ability to remain employed, but for older people to stay employed longer it is also necessary to adjust working conditions, while incentives for a longer period of employment must also stem from the pension system (more in Section 2.2.4.). As shown in Table 3 in Section 1.2., the employment rate in this age group did increase the most but still remains exceptionally low. In 2007 and also in the years covered by the analysis, Slovenia ranked among the countries with the lowest employment rates for older people and did not stand out from the other countries in the sixth group. The employment rate of older workers in Sweden, which has the highest employment rate of older workers, is two times higher than in Slovenia (see Figure 10). As shown in Section 1.2, Slovenia has a particularly low employment rate of older women. The main causes for the low employment rate for older women in Slovenia are: 1) massive early retirement at the beginning of the 1990s; 2) current lower average retirement age in comparison to other countries, and 3) structural unemployment, which largely affects older people, who are also less included in lifelong learning. A relatively early exit from the labour market in Slovenia, which is also reflected in the low employment rate for older persons, indicates the need for pension system reform. The necessity to additionally adjust the pension system to demographic changes is also shown by

the fact that the increase in the average retirement age decelerated considerably after 2005 and that the average retirement age in Slovenia is 1.4 years below the EU average.

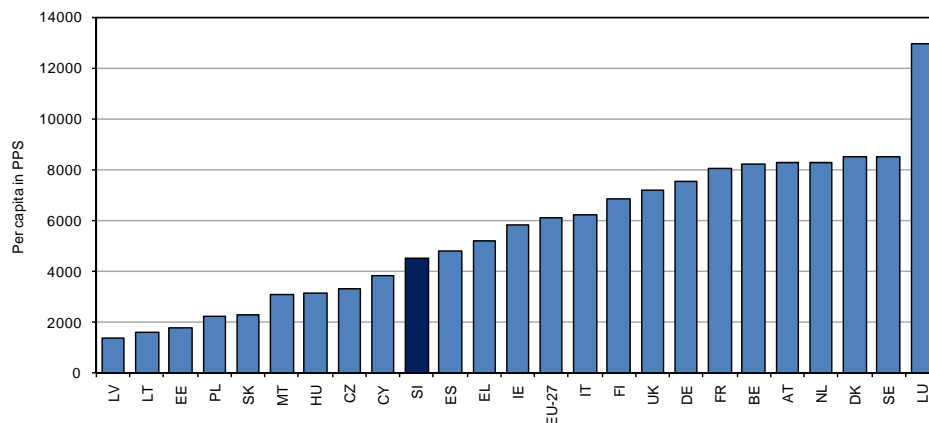
Figure 10: Employment rate of older workers (aged 55–64) in 2007, in %.



Source: Eurostat

*The amount of funds the state earmarks for social protection is also an indicator of flexicurity.* Slovenia earmarked 23.4% of GDP for social protection in 2005 and stood out from the group in which it was classified in the above analysis of flexicurity models, but at the same time it lags far behind the Nordic countries. As is evident from Figure 11, a similar picture is also shown by the indicator of the amount of expenditure for social protection per capita in purchasing power standards.

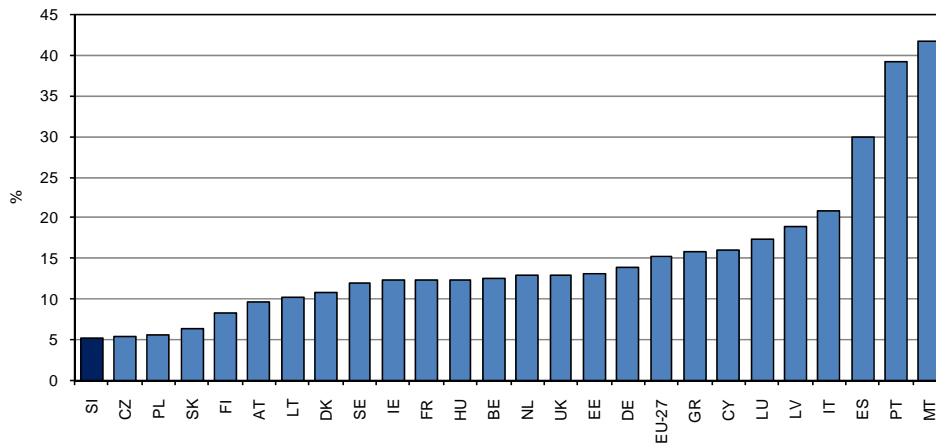
Figure 11: Expenditure for social protection per employee in purchasing power standards, 2005



Source: Eurostat

*Criteria for social inclusion indicate a relatively favourable position of Slovenia.* Together with the Czech Republic and Slovakia, classified in the sixth group of countries, Slovenia ranks among the countries with the lowest at-the-risk-of-poverty rates in the EU, while in Hungary and Poland poverty presents a bigger problem. In 2006, the at-the-risk-of-poverty rate in Slovenia (12%) was similar to that in the Nordic countries. A similarly favourable picture for Slovenia and other countries in the sixth group is also shown by the indicator of early school leavers, where the share of young people aged between 18 and 24 who are not included in education is the lowest among the EU Member States (see Figure 12). According to the income inequality indicator (measured with the Gini coefficient), Slovenia stands out from the other countries in the sixth group, as it ranks among the countries with the smallest differences in income.<sup>31</sup>

Figure 12: **Early school leavers, in 2006**



Source: Eurostat

## 2.2. Components of flexicurity – situation and changes in the system in Slovenia

*As Slovenia has opted to introduce flexicurity, we present the measures adopted in the last two years.* In accordance with the definition of the flexicurity concept at the EU level, we present the changes in the following areas: 1) flexible employment contract relationships; 2) effective active labour market policy; 3) lifelong learning system, which provides employees with adaptability and employability; and 4) social security and tax systems which encourage employment and postponement of exiting from the labour market.

<sup>31</sup> Only Sweden and Denmark had a lower discrepancy in 2004.



### 2.2.1. Flexible employment contract relationships

***Amendments to the Employment Relationship Act, aimed at providing more flexibility, were adopted in 2007.*** These amendments provide for an increase in internal flexibility by introducing employment by type of work<sup>32</sup> and possibilities for longer overtime work (more flexible regulation of working time). To a certain extent, the amendments provide for an increase in external flexibility by expanding the possibility of using flexible forms of employment (fixed-term employment) and changes regarding easier termination of employment contracts (severance payments – an offer of employment at another employer, shortening of notice periods). Overtime work can also exceed the annual time limit for overtime work (which is being decreased from 180 hours to 170 hours), namely 230 hours a year at most on the basis of the written consent of the worker.

***Possibilities for fixed-term employment were increased in order to achieve better flexibility.*** The amendments expanded the possibilities for fixed-term employment to include cases when none of the applicants fulfils the required conditions for the job, in cases of employment of managers and employment on a project. The exception from the universal two-year time limit for conclusion of fixed-term employment contracts in the case of preparation and implementation of work organised as a project<sup>33</sup> is also important.

***Dismissal costs decreased somewhat with the reduction of notice periods.*** The amount of severance payments was not changed. However, the changes introduced an option under which an employer is not obliged to pay out severance pay when the Employment Office or the employer offers the employee, upon the termination of the employment contract and during the time of the notice period, an employment contract with another employer and the employee concludes this contract. Certain notice periods in case of termination due to business reasons were reduced, as follows: 1) from 75 days to 60 days – if the worker has at least 15 years of service with the employer, and 2) from 150 days to 120 days – if the worker has at least 25 years of service with the employer. The amendments, therefore, did not result in a substantial reduction of dismissal costs, which are in economic theory an important reason for employers' caution in the employment process (the amount of severance payments remain unchanged, while notice periods are reduced only for certain groups of workers). We estimate that major changes in this area were not possible because they were not supported with measures providing higher income security and measures for greater adaptability of employees (lifelong learning).

***Certain obstacles to employers' interest in part-time employment were reduced.*** The amendments to the Act clearly defined the principle of proportionality of rights of part-time employees with respect to the length of working time.

***The amended Prevention of Illegal Work and Employment Act opens employment possibilities for short-term work and small work.*** Under the amendments, short-term work (unpaid work in a micro company or private

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<sup>32</sup> The introduction of the possibility of employment by type of work increased the possibility for transfer of workers within a company and better adjustment of work to the needs of the working process.

<sup>33</sup> A fixed-term contract may be concluded for the duration of the project.

institution, or for an entrepreneur with 10 employees at the most, when performed by a spouse of the entrepreneur, owner or co-owner of the company or private institution, or a person to whom he or she is related to the first degree, and which lasts 40 hours a month at the most) is not considered as undeclared employment. Under the amended legislation, small work<sup>34</sup> is not considered as undeclared work.

***The possibility to establish specialised temporary work agencies was introduced in 2006.*** The amendments to the Employment and Insurance Against Unemployment Act made the establishment of such agencies easier. Under the new legislation, such an agency can acquire the right to provide temporary work only with its entry in the registry of agencies providing temporary work and does not have to conclude a concession contract as other employment agencies do.

### 2.2.2. Active employment policy

***Legal and conceptual bases for improving the effectiveness of active labour market policy were adopted in the last two years, but implementation problems exist.*** At the end of 2006, the Government of the RS adopted new guidelines for active labour market policy: the Active Labour Market Policy Programme for the period 2007–2013 (ALMP) and the Implementation Plan of the Active Labour Market Policy Programme for the years 2007 and 2008. New rules on the implementation of the active employment policy, which enables a more rational labour market policy, were also adopted. The Active Labour Market Policy Programme for the 2007–2013 period was designed to eliminate problems related to the adoption of programmes for individual calendar years, which prevented the implementation of long-term programmes and caused difficulties in their funding. The Active Labour Market Policy Programme for the period 2007–2013 set up strategic objectives and envisaged four sets of programmes: 1) counselling and assistance for employment; 2) training and education; 3) promotion of employment and self-employment; and 4) programmes for increasing social inclusion. The planned changes to the ALMP which would lead to better effectiveness have still not been implemented. The Implementation Plan of the Active Employment Policy Programme for the years 2007 and 2008 was adopted only in mid-May 2008, which causes difficulties in the implementation of activities in this area. The annual action plan for the implementation of active labour market policy programmes in 2008 and 2009 does not follow the increase in the share of funds for education and training planned in the mid-term ALMP programme for the period 2007–2013. Bi-annual action plans for ALMP programmes differ from mid-term plans considerably, notably in the area of funds intended for counselling and assistance for employment. From the aspect of the creation of flexicurity, it would be more appropriate to implement the guidelines. We assess that it would be useful for employment policy management if the bi-annual plans adopted by the Government of the RS also envisaged inclusion of the number of unemployed persons in ALMP programmes.

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<sup>34</sup> Small work is defined as work lasting 20 hours a week at the most and not more than 40 hours a month, while payment for this work does not exceed 50% of the minimum wage determined by the law if such work is carried out by a person who is not in a full-time employment relationship, who does not pursue an independent activity and does not receive a pension.

*From the aspect of flexicurity, we will emphasise primarily education and training programmes for the employed and unemployed.* The ALMP contains programmes for institutional training, on-the-job training and integrated programmes for training, formal education and national professional qualification (NPQ).<sup>35</sup> Although education and training programmes are successful from the aspect of increasing employability, the share of the unemployed included in these programmes decreased in 2007 (see Table 10)<sup>36</sup> and is too small from the aspect of the provision of flexicurity in the labour market. Co-funding of education and training of employees increased in the last two years by means of tenders of the European Social Fund, which is also important from the aspect of preserving employment.<sup>37</sup> Great employer response and interest in co-funding confirm the need to strengthen such programmes and create similar tenders for co-funding of education and training in small and medium-sized companies.

**Table 10: Number of unemployed persons included in education and training programmes**

	2005	2006	2007
Institutional training programmes	1,903	3,290	3,860
National professional qualification	419	3,041	205
Practical training programmes	-	-	2,905
Work test	1,897	1,783	2,210
On-the-job training	2,064	3,778	695
Educational programmes	-	-	5,912
Formal education	-	1,347	2,898
Project Learning for young adults	222	82	215
Improvement of computer literacy of unemployed persons	-	15,686	-
<b>TOTAL NUMBER OF UNEMPLOYED PERSONS INCLUDED IN EDUCATION AND TRAINING PROGRAMMES</b>	<b>12,173</b>	<b>29,007</b>	<b>19,626</b>
Share of unemployed persons included in these programmes out of the average number (in %)	13.2	33.8	27.5

Source: Reports on the implementation of the ALMP by the Employment Service of Slovenia, calculations by IMAD

*From the flexicurity aspect, programmes aimed at increasing social inclusion are also important.* In this area, unemployed persons were newly included only in public works programmes and employment programmes for non-profit employers in 2007. These programmes are important primarily from the aspect of activation of unemployed persons, prevention of poverty and promotion of work activity, and thus it is worrisome that the number of new inclusions in such programmes decreased considerably in the last two years.<sup>38</sup> The Active Labour Market Policy Programme for the period 2007–2013 envisages the creation of a system of in-work benefits.

<sup>35</sup> National professional qualification is the professional or vocational competence necessary to perform a profession or individual sets of responsibilities within a profession at a specified level of difficulty. Individuals use the acquired NPQ when searching for employment and in formal education.

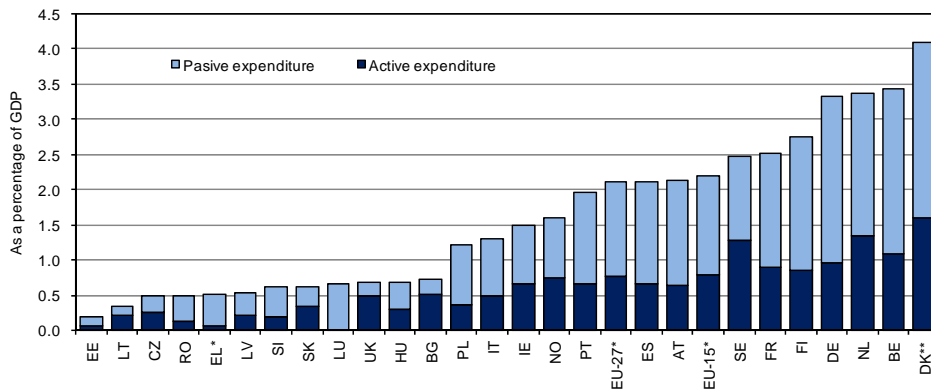
<sup>36</sup> The year 2007 saw a great delay in the publication of the tender for the on-the-job training programme and difficulties in its implementation. Since the preparations for the confirmation of national professional qualification (NPQ) were not carried out in the form of a special programme, a considerably smaller number of unemployed were included in the confirmation of NPQ than in previous years.

<sup>37</sup> About 33,000 employees in 2007 were included in education and training programmes in sectors being reformed and in promising sectors.

<sup>38</sup> Reports on the implementation of ALMP measures indicate that the number decreased from 10,602 in 2005 to 3,579 in 2007.

*Slovenia earmarks a relatively small amount of funds for employment policy.* According to Eurostat, Slovenia spent only 0.6% of GDP for labour market policy in 2005, of which only 0.2% of GDP was spent on active labour market policy measures. This ranks Slovenia among the EU Member States that spend the least money for labour market policy (see Figure 13).

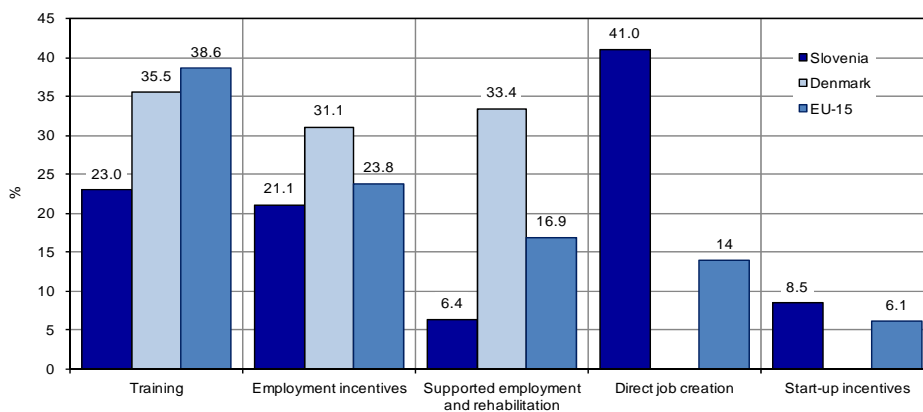
Figure 13: Public expenditure on the labour market in 2005, in % of GDP



Source: Eurostat, Statistics in Focus 45/2008  
Notes: \*Estimate by Eurostat for EU-27 and EU-15, \*\*Data for Denmark is for 2004

*Expenditure for direct job creation stands out in the structure of expenditure for active labour market policy in Slovenia, while the share for training programmes is too small.* Because training programmes are more important from the aspect of flexicurity, their share in the structure should be increased. Expenditure for education and training stands out in the expenditure structure of Denmark, which is synonymous with flexicurity, and the EU average (see Figure 14).

Figure 14: Structure of expenditure on labour market programmes by category in 2005, Slovenia, EU-15 and Denmark



Source: Eurostat, Statistics in Focus 45/2008

***The lack of assessment of the effectiveness of programmes and difficulties with data occurred in the field of labour market policy analysis in Slovenia.*** Conducting effective active labour market policy requires better availability of data on participation in programmes and external evaluations of programmes by research methods.

### 2.2.3. Lifelong learning

***In 2006, a new National Professional Qualifications Act, which introduces a system of recognition of non-formal and informal learning, was adopted.*** In 2006, a new National Professional Qualifications Act, which introduces the system of national professional qualifications (NPQ),<sup>39</sup> was adopted. In the 2007/2008 school year, recognition of informal knowledge also started to be implemented in secondary vocational and professional education. The NPQ system in Slovenia represents the main system for recognition of non-formal and informal learning (for the needs of work and for continuation of formal education), although the implementation of the system is accompanied by certain problems (poor connection between NPQ certificates and the wage system, insufficient inclusion of social partners, non-recognition of NPQ certificates, etc.).

***Certain new measures should be developed to stimulate lifelong learning.*** The Lifelong Learning Strategy was adopted in 2007, but the expansion of lifelong learning is hindered by the fact that Slovenia has still not adopted the operational programme for the implementation of the Lifelong Learning Strategy and failed to implement various measures and activities for increasing participation of the population in lifelong learning. The Resolution on the national programme of higher education of the Republic of Slovenia 2007–2010, adopted last year, envisages an increase in the share of the population participating in all forms of lifelong learning and, within this framework, the development of programmes for returning to tertiary education programmes for employees, the unemployed and inactive persons. Certain measures should be developed for reaching this objective. Implementation of certain measures in the area of lifelong learning is also imposed by the Social Agreement for the Period 2007–2009, which among other things envisages promotion of education and training of employees whose jobs will probably be endangered, introduction of incentives for companies which invest in education of employees, and setting up funds for education. The Guidelines for the development strategy for fundamental skills and literacy of employees were drafted as well.

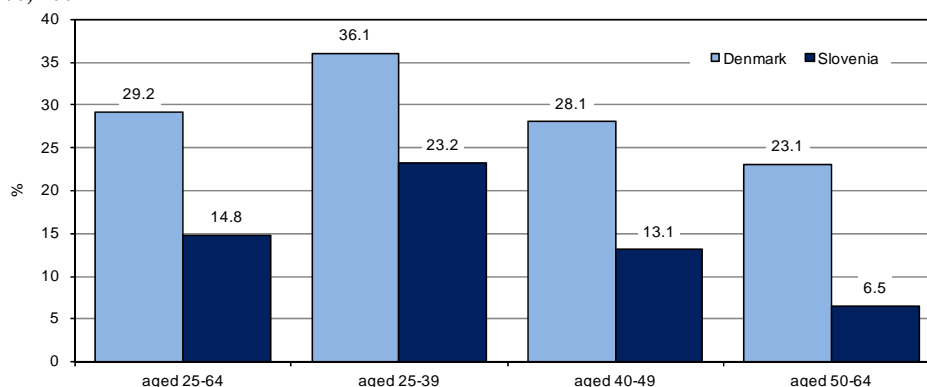
***The participation of the population in lifelong learning is relatively high, but decreases rapidly with age.*** In Slovenia in 2007, the participation rate of the population aged 25–64 in various forms of lifelong learning (formal and non-formal education) reached 14.8% (in 2006: 15.0%), which puts Slovenia above the EU-27 average (9.7%) but is still considerably below certain North European countries (see Figure 9 in Section 2.1.2.). Moreover, in Slovenia the participation

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<sup>39</sup> National professional qualification is the professional or vocational competence necessary to exercise a profession or individual sets of tasks within a profession at a specified level of difficulty. Individuals use the acquired NPQ in searching for employment and in formal education.

rate of the population in lifelong learning rapidly decreases with age (see Figure 15),<sup>40</sup> although participation in lifelong learning is an important factor for preserving competitiveness in the labour market and for maintaining employment in both younger and older life periods. In terms of the participation of adults in lifelong learning, Slovenia lags far behind Denmark. Denmark reaches the highest rates of participation in lifelong learning in the EU in all age groups and is frequently mentioned as a benchmark model of flexicurity. As shown in Figure 15, participation in lifelong learning in Slovenia declines with age considerably faster than in Denmark, and a similar trend is also indicated by the data for the EU average.

Figure 15: Participation of the population in lifelong learning, by age, Slovenia and Denmark, %, 2007



Source: Population and Social Conditions Eurostat – Education (Eurostat), 2008

**Low participation of adults, especially among the unemployed, in secondary education is also a problem in Slovenia.** The number of adults in secondary schools has been declining; in the 2006/2007 school year, a total of 14,956 adults were enrolled in secondary schools, which was 13.3% less than in 2005/2006 and 28.4% less than in 2000/2001. In 2006, 0.8% of the population aged between 25 and 64 were attending secondary school (in 2000: 0.5%), which is less than in 2005. The participation rate of adults in tertiary education is higher; in the 2006/2007 academic year it totalled 3.4% and increased by 1 percentage point in the 2000/2001–2006/2007 period. Although the unemployment rate is the highest for people with primary education or incomplete primary school, the number of unemployed enrolled in secondary schools has been decreasing.<sup>41</sup>

<sup>40</sup> Source: Eurostat, calculations by IMAD

<sup>41</sup> There were 1,892 students enrolled in high schools in the 2006/2007 academic year (in 2005/2006: 3,044), which is also the lowest figure in the 2000/2001–2006/2007 period.

#### 2.2.4. Social security systems

***The concept of flexicurity requires the creation of modern social security systems which combine income support and incentives for employment.*** In the last two years, there have been no major systemic changes in the area of income security provision in Slovenia, whereas there were changes in the tax system (see the chapter "Fiscal Development and Policy" for more details), for which we can conclude that they led to changes in incentives to work, which are presented in this section. As the creation of incentives to keep older workers in employment longer is also regarded as a part of flexicurity, we also analyse these incentives and possibilities for part-time retirement, which in certain countries enable a gradual exit from the labour market. Despite the fact that the topic of social protection systems and provision of income security is very comprehensive, we have only analysed the aforementioned issues at this time.

***Changes in the system in the area of social protection were implemented in the last two years primarily oriented towards increasing the obligations of the unemployed, while there were no major changes in the area of income security provision.*** The Employment and Insurance Against Unemployment Act (EIA) increased the obligations of unemployed persons in terms of acceptance of employment, requiring that unemployed persons accept work after a specified period which requires up to two levels lower education than theirs. Amendments to the EIA eliminated the right to unemployment assistance in the system of insurance against unemployment by merging it with the right to social assistance given by social work centres. Such a change rationalises the system of granting but is not a step towards providing flexicurity. Commitments of the recipients also increased with the amendments to the Social Security Act and the introduction of a new reason for the expiration of entitlement to social assistance (unfounded rejection of adequate employment under a subcontract, authorship contract, or adequate humanitarian or other similar work). Amendments to the above acts did not bring major changes in the area of income security provision.

***There are special indicators to determine conditions for making work pay.*** Making-work-pay indicators, which were calculated this year by the Statistical Office according to the slightly adjusted methodology of the OECD, show effects on net income in the case of transitioning from unemployment to employment and from less-paid jobs to better-paid jobs. This is shown primarily by two indicators: the unemployment trap<sup>42</sup> and low-wage trap.<sup>43</sup> As unemployment has the biggest influence on people's slipping below the poverty threshold, incentives for employment are also a means for preventing poverty.<sup>44</sup>

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<sup>42</sup> The unemployment trap indicator shows the difference in net incomes in transitioning from unemployment to employment because of higher taxes and social contributions and lower associated social transfers in employment in comparison to incomes in higher associated social transfers during unemployment. The calculation is made under the assumption that an employed person receives 67% of the average gross wage of employed persons.

<sup>43</sup> The low-wage trap indicator shows the ratio in net incomes of employed persons in transitioning to a better-paid job (from 33% to 67% of the gross average wage for employed persons), with the ratio changing because of higher taxes and social contributions and lower associated social transfers in comparison to previous lower incomes, consequently lower taxes and social contributions and higher associated social transfers.

<sup>44</sup> A situation can occur in which poor unemployed persons do not opt to be employed, as they would lose certain social transfers and their net income after taxation and social security contributions would be lower than before employment. Meanwhile, persons with low incomes do not decide to take better-paid jobs for the same reasons.

***Incentives to work improved slightly in the 2001–2007 period.*** In the 2001–2007 period, the unemployment trap decreased by 1.9 percentage points. The low-wage trap for a single person without children in the same period increased and decreased for couples with two children (see Table 11).

***Incentives to work improved in 2007 in comparison to 2006.*** The unemployment trap decreased by 1.5 percentage points, but still remains high. The low-wage trap is somewhat lower, and it also decreased in comparison to the year before. In 2007, single persons increased their net income by EUR 0.49 upon the transition to a better-paid job for each additional euro of the gross wage (in 2006: EUR 0.484), while couples with two children increased their net income by EUR 0.326 for each additional euro of their gross wages (in 2006: 0.274 EUR). Transitioning to a better-paid job is still more favourable for a single person than that for a couple with two children.

Table 11: **Certain indicators of incentives to work, Slovenia, 2001–2007**

	Unemployment trap in %	Low-wage trap, in %	
	Single person without children	Single person without children	Couple, one employed person, two children
2001	82.6	39.1	99.4
2002	84.4	42.7	95.5
2003	86.1	46.1	94.8
2004	87.7	49.1	91.9
2005	82.6	50.8	76.4
2006	82.2	51.6	72.6
2007	80.7	51.0	67.4

Source: SORS Work incentives indicators, Slovenia, 2007 – PRELIMINARY DATA, 14 May 2008, First publication

***Slovenia ranks among countries with relatively modest incentives to work.*** The unemployment trap in Slovenia in 2007 was above the EU average, and the low-wage trap was also higher, both for single persons and couples with two children (see the chapter "Fiscal Development and Policy").

***The pension system is also important for the creation of a flexicurity model.*** Flexicurity is also partly created by incentives aimed at keeping older workers in employment longer and more flexibility in forms of employment of older workers. Better flexibility for older (secured) employees and those who already meet the conditions for retirement, or are already retired, is enabled with regular employment for a shorter working time (by agreement between the employer and the employee) or with partial retirement or part-time employment (by agreement between the employer and the employee). Partial retirement enables a gradual exit from the labour market. Incentives to keep employees employed which arise from the pension system also influence keeping older persons in employment.

***Incentives for staying employed longer were introduced with pension reform in 2000.*** Incentives incorporated in the pension system primarily include increasing the overall accrual rate for each year of activity after the fulfilment of retirement conditions and increasing pensions for those who retire after they reach full retirement age. Table 12 shows calculations of increases in pensions related to the pensions upon full retirement age, which indicate that postponing retirement after reaching the retirement age by four years increases the accrued pension upon the



full retirement age by 15.4%. Despite the incentives for longer activity, relatively few insured persons opt for prolonging their working age.

Table 12: **Increase of pensions due to postponing retirement**

<b>Period of postponed retirement after reaching full retirement age, in years</b>	<b>Index of the pension increase level<sup>1</sup> compared to the pension at full retirement age</b>
0	100.00
1	105.54
2	110.06
3	113.40
4	115.41
5	117.42
6	119.44
7	121.45

Source: Calculations by IMAD

Note: <sup>1</sup>The increase in the pension level is a result of the increase in the accrual rate and allowance for activity after reaching full retirement age (63 years for men, 61 years for women).

***The possibility of partial retirement is rarely exercised in Slovenia.*** At the end of 2007, 184 persons retired in such a way. The reasons for this are the following: 1) partial retirement requires fulfilment of conditions for full age retirement; 2) partially remaining in employment requires the consent of the employer; 3) for the majority of those reaching full retirement age, the decrease of income upon partial retirement is too great in comparison with the wage. The reason for such a decrease in income is a low accrued pension and taxation of pension income.<sup>45</sup>

<sup>45</sup> A pension represents net income already taxed through the translation of the gross pension basis to the net pension basis, while the tax arrangement taxes it once again as if it were employee income.

### 3. Conclusion and labour market challenges from the aspect of flexicurity

Unemployment decreased in the 2000–2007 period, with the unemployment rate dropping to 4.9% in 2007. The unemployment rate in Slovenia in this period decreased faster than the EU-27 average and the average of the old EU Member States (EU-15). The long-term unemployment rate also decreased (from: 4.1% in 2000 to 2.2%, in 2007). However, the following problems in the area of unemployment remain: a high share of long-term unemployment, unemployment of youth (15–24 years) and older people (over 50 years), and an increasing number of registered unemployed persons with a tertiary education.<sup>46</sup>

Employment increased along with the rate of employment. In the 2000–2007 period the number of persons in employment in Slovenia increased at an average annual rate of 1.4%, which was above the EU average. The employment rate of the population (aged between 15 and 64) in Slovenia in 2007 increased to 67.8%, which was above the EU average; the employment rate for women was above the EU average and for men below the EU average. The employment rates of younger (15–24 years) and older workers (55–64 years) remained relatively low. They represent an important share of "reserves", which is not high in the group aged between 25 and 54, for increasing the employment rate in Slovenia. From the aspect of increasing the employment rate for younger and older workers, another challenge is the organisation of working environment and conditions which will enable longer work activity of older people and smooth the entry of young people into employment (development of so-called age management of human resources, which will combine the experience and knowledge of older people with the knowledge and enthusiasm of young people).

As a response to the challenges of globalisation, the concept of flexicurity was created in the EU and also became Slovenia's objective with the revised Lisbon Strategy. The integrated concept of flexicurity is made up of four components which are combined to create a dynamic labour market and provide security to individuals: 1) flexible employment and contractual relationships, based on modern labour legislation, are flexible both for employers and employees, and reduce segmentation of the labour market and undeclared work; 2) active labour market policy, which effectively assists people in unemployment and enables them to transition to new employment; 3) the system of lifelong learning, which is reliable and provides employees with adaptability and employability; and 4) modern social security systems, which adequately combine the system of income support and incentives for employment and mobility in the labour market.<sup>47</sup> Slovenia also opted for the formulation of the flexicurity concept.

The first analysis of flexicurity models by Phillips and Eamets (2007) placed Slovenia in the group of countries with great challenges in the field of flexicurity. Along with Poland, Hungary, the Czech Republic and Slovakia, Slovenia ranked in a group characterised by: modest labour market mobility, high long-term

<sup>46</sup> Data on registered unemployed indicate that the average number of unemployed persons with tertiary education in 2007 was 50% higher than in 2000, and their share in overall unemployment increased from 4.4% in 2000 to 10% in 2007.

<sup>47</sup> Common Principles of Flexicurity – Council Conclusions, 6 December 2007.

unemployment and a low employment rate for older people, which indicates modest labour market flexibility, which is combined with high income protection and low social trust. Challenges facing these countries are improving labour market flexibility and ensuring income security. This paper attempts to show and evaluate policies and measures in the field of creating flexicurity carried out in Slovenia over the last two years.

From the point of view of flexicurity, the following problems occur in the labour market: long-term unemployment, a low employment rate for older persons and a modest prevalence of part-time employment. Since long-term unemployment decreases human capital, programmes within active labour market policy which prevent transitioning to long-term unemployment should be developed and strengthened from the aspect of flexicurity. Slovenia has one of the lowest employment rates for older persons in the EU. A low employment rate for older people, which is especially low for women, is a major challenge for economic and labour market policies. Within ALMP, it would be reasonable to strengthen programmes which stimulate employment of older persons, while changes in the pension system aimed at encouraging a postponed exit from the labour market are necessary as well. The necessity of additional adaptation of the pension system to demographic changes is also indicated by the fact that the increase in the average retirement age decelerated considerably after 2005 and that the average retirement age in Slovenia is 1.4 years below the EU average. The share of part-time employment, which usually represents a "friendly" form of flexible labour, is still relatively low despite having increased recently. Part-time employment represents an opportunity to increase flexibility and the employment rate. We estimate that the main reasons for its modest prevalence in Slovenia are primarily: 1) modest interest from employers, as employing several persons part-time is still more expensive than employing one person full-time, despite last year's amendments to the Employment Relationship Act; and 2) modest interest on the part of employees because of the low income level provided by such employment.

Among flexible forms of employment, temporary employment, which usually does not provide flexicurity, is increasingly used in Slovenia. The share of temporary employment in total employment more than doubled over the last ten years and has been increasing considerably since 2003 with the acceleration of economic growth. The share of temporary employment in total employment in Slovenia exceeds the EU average. A high share of temporary employment is often the result of high dismissal costs and difficulties related to dismissals. Flexibility of the labour market in Slovenia has increased primarily through temporary employment, the frequent use of which, similar to unemployment, decreases the wellbeing of individuals according to a study by Malenfant, LaRue and Vezina (2007). Young people are increasingly exposed to temporary employment, which causes age segmentation of the labour market. From the aspect of flexicurity, the problem consists in the relatively "strict" conditions (eligibility criteria) for acquiring unemployment benefits, and thus it is difficult for young people with frequent temporary jobs to acquire such benefits. Because of the large share of temporary employment, adequate income support for the unemployed, who are often employed for a fixed period of time, should be considered from the aspect of the creation of flexicurity.

A review of measures taken in the four key areas of flexicurity shows that changes in the last two years were primarily focused on achieving flexibility of contractual relationships. Amendments to the Employment Relationship Act in 2007 were aimed at better internal flexibility (employment by type of work), possibilities of employment for a fixed period of time were expanded, and certain obstacles to employers' interest in part-time employment were also reduced. The amendments to the Employment Relationship Act aimed at providing greater flexibility were not radical and did not result in a substantial reduction of dismissal costs, which are in economic theory an important reason for employers' caution in the process of hiring (the amount of severance pay remains unchanged, with notice periods reduced only for certain groups of employees). We assessed that greater changes in this area were not possible because they were not supported with measures providing higher income security and measures for greater adaptability of employees (lifelong learning).

Active labour market policy, lifelong learning and social security systems in Slovenia still do not play an appropriate role in the creation of flexicurity. Active labour market policy must provide a quick and easy transition between jobs. Training programmes for the employed and unemployed should therefore be strengthened in Slovenia. Participation of less skilled and older persons should be increased. In the area of education and training of employees, it would be reasonable, in addition to tenders for co-funding the education and training of employees in companies undergoing restructuring and in promising activities carried out in the last two years, to create tenders for co-funding education and training in small companies as well. Despite the high rate of participation of adults in lifelong learning, participation of older persons and less skilled persons is too low to contribute to creating conditions for flexicurity. In the area of social security, the amendments to the Social Security Act and the Employment and Insurance Against Unemployment Act primarily increased the obligations of the unemployed in terms of accepting employment, which was not followed by the creation of in-work benefits.

Creation of a flexicurity model remains a great challenge for Slovenia. Creation of flexicurity requires a more integrated approach to ensure mutual support and coordinated implementation of all four policies. More flexibility will not be possible without support from other flexicurity policies, primarily 1) provision of greater participation of older and less trained people in lifelong learning; 2) effective active labour market policies which would prevent transitioning into long-term unemployment and focus largely on the transition between jobs through adequate educational and training programmes for the employed, and 3) provision of income security, also in the case of unemployment.

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