

**PUBLIC EXPENDITURE IN SLOVENIA: PAST TRENDS AND  
CURRENT ISSUES**

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Abstract

*This paper reviews expenditure developments in Slovenia since its independence. It provides a description of their movements and tries to find reasons behind them. An attempt is also made to estimate possible future trends, mainly taking into account the possible impact of population ageing on expenditure.*

*The main conclusions can be summarised in the following five points. First, as general government deficit fluctuates at approximately 2% of GDP, close to the Maastricht reference value, a clear need exists to improve the fiscal position. Second, there is a need to make expenditure more flexible and to restructure the current expenditure mix. Third, the pension reform in 2000 along with the restrained growth of individual wages in the public sector in the last few years have been the main successes in the field of expenditure policy. Fourth, additional pressure on expenditure due to the ageing of the population can nevertheless be expected, intensifying especially after 2020 if no measures are taken. Fifth, there is a need to lower the general level of expenditure.*

Keywords: fiscal policy, government expenditure, age related expenditure.

Povzetek

*V članku analiziramo gibanja javnofinančnih izdatkov v Sloveniji v obdobju po osamosvojitvi. Opisujemo njihova gibanja in poskušamo najti razloge zanje. Poskušamo oceniti tudi njihova možna gibanja v prihodnosti, v največji meri upoštevaje pričakovane učinke staranja prebivalstva.*

*Glavne ugotovitve lahko povzamemo v naslednjih petih točkah. Prvič, glede na to, da se trenutno primanjkljaj sektorja države giblje okrog 2% BDP, blizu maastrichtske referenčne vrednosti, je prisotna potreba po izboljšanju fiskalnega položaja. Drugič, javnofinančni izdatki bi morali biti bolj fleksibilni, njihova struktura pa se mora spremeniti. Tretjič, pokojninska reforma iz leta 2000 in omejitve rasti povprečne plače v javnem sektorju v zadnjih nekaj letih, predstavljata glavni uspeh na področju politike javnofinančnih izdatkov. Četrto, dodatni pritiski na javnofinančne izdatke so pričakovani zaradi staranja prebivalstva, predvsem po letu 2020, če ne bodo sprejeti dodatni ukrepi. Petič, potrebno je znižati raven javnofinančnih izdatkov.*

Ključne besede: fiskalna politika, javnofinančni izdatki, starostno pogojeni izdatki.

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The views expressed in the paper are those of the author and do not necessarily represent those of the Bank of Slovenia.

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## INTRODUCTION

After gaining independence the aim of fiscal and general government expenditure policy in Slovenia was to support economic stabilisation. This goal had been successfully achieved by 1997, and thereafter fiscal policy has been increasingly oriented to issues connected to European Union membership, which Slovenia took on May 1st, 2004. Current fiscal policy in Slovenia and, in particular, expenditure policy should be viewed in terms of the further fulfilment of the Maastricht fiscal criteria in order to adopt the euro as soon as possible. Slovenia joined ERM II in June 2004, and is striving to adopt the euro at the beginning of 2007. In such circumstances the design of an appropriate policy mix is vital, and fiscal policy has a decisive role.

General government accounts show at present a deficit of around 2% of GDP, according to the ESA95 methodology, which is relatively close to the 3% reference value. Due to European Union fiscal rules and also due to medium- and long-term fiscal challenges, countries should strive in general for balanced budgets in the medium term to provide the safety margins needed to comply with the European Union fiscal framework and specifically to deal with future ageing pressures.

Currently, the share of the general government sector in Slovenia is quite large – as in the most European Union countries – with expenditure amounting to around 48% of GDP according to the ESA 95 methodology (see annex I)<sup>1</sup>. Although this share has been quite stable in recent years, the expenditure share greatly increased after independence, but was not supported by the same increase in the revenue ratio.

This paper reviews expenditure developments in Slovenia since its independence. The purpose of this paper is twofold. First, it provides a description of expenditure movements. We focus on the trends and seek factors to explain them. Second, an attempt is also made to estimate possible future trends in some expenditure categories, mainly taking into account the possible impact of population ageing on expenditure.

The paper is organised as follows. The first part comprises a short description of the evolution of general government balance and expenditure in the past years. Some basic characteristics are also discussed. This is followed in the second part by a description of past movements in the most important expenditure categories, along with their recent developments, and short- and, where relevant, long-term prospects. The third part deals with the need for an adjustment process. Conclusions are given in the fourth part.

The main conclusions can be summarised in the following five points. First, as general government deficit fluctuates at approximately 2% of GDP, close to the Maastricht reference value, a clear need exists to improve the fiscal position. Second, there is a need to make expenditure more flexible and to restructure the current expenditure mix. Third, the pension reform in 2000 along with the restrained growth of individual wages in the public sector in the last few years have been the main successes in the field of expenditure policy. Fourth, additional pressure on expenditure due to the ageing of the population can nevertheless be expected, intensifying especially after 2020 if no measures are taken. Fifth, there is a need to lower the general level of expenditure.

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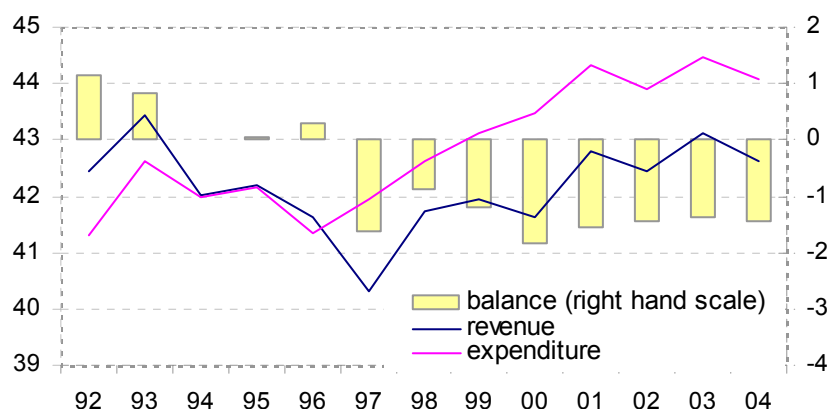
<sup>1</sup> Comparing the level of expenditure to GDP ratio can be somewhat problematic, as countries can achieve public finance goals in different ways.

## 1. THE EVOLUTION OF GENERAL GOVERNMENT BALANCE AND EXPENDITURE AFTER INDEPENDENCE

In early 1990s, that is in a period after independence, key role of fiscal policy and public expenditure management was to help achieving macroeconomic stabilisation and to ensure smooth transition from a market socialist economic system to a fully-fledged market system. Upon independence the first thing on the expenditure side was to abolish fiscal “self-management”, which meant fragmentation of public expenditure into hundreds of programs at the local community level. They were organised in the form of independent budgets, the so-called self-management interest associations (for social care, infrastructure, education and so on). After this change, government functions have been centralised (Cvikl, Gaspari, 2004).

In the first period Slovenia showed a surplus in general government accounts<sup>2</sup>. Accounts moved into deficit in 1997 and thereafter the deficit has increased to reach a peak in 2000 before calming down to 1.4% of GDP in 2004. While in the first part of the 15-year period the expenditure ratio has declined as a percentage of GDP, it grew thereafter and increased from 1996 to 2004 by some 3 percentage points.

Chart 1: General government accounts, 1992-2004 (in % of GDP).



Source: Ministry of Finance of the Republic of Slovenia. Data has been adjusted for a shift in indirect taxes and flows to/from the European Union budget have been excluded from 2004 data.

The aim of a government fiscal policy is at present to reach a structural position close to balance. This is to be done in an environment of a decreasing or at least unchanged tax burden. This means that the expenditure ratio should be adjusted in order to reach the target each year.

### *Expenditure structure*

In terms of expenditure policy not only the level of expenditure, but also the structure matters. The former reflects the amount of distortions, while the latter has important

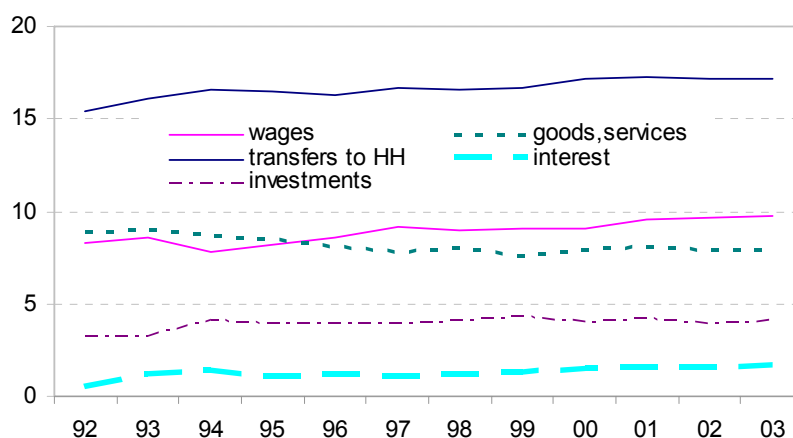
<sup>2</sup> General government data, as defined by the national methodology, is mainly used. The general government sector is comprised of central government, health and pension funds, and local government. The reason we use data based on the national methodology is their availability throughout a longer period (from 1992 on). Data consistent with ESA 95 methodology were published by the Statistical Office for the first time in August 2004, but covered only the period 2000 to 2003. Data for 2004 was published in April 2005. When deemed necessary, this data will also be used, but indicated separately.

consequences for the effectiveness of expenditure policy. High levels of expenditure mean that the adjustment should be considerable, and this normally means a break with past behaviour.

Analysis available so far shows that in improving budgetary performance, adjustments through spending cuts can be more successful than tax increases. Such a conclusion can be found for example in Alesina and Perotti (1995). Afonso, Nickel and Rother (2005) find that since the early 1990's expenditure based consolidations seem to be more successful in Central and Eastern Europe than revenue based<sup>3</sup>. The same conclusion has been drawn for EU-15 in the paper by Briotti (2004), which focuses on the fiscal adjustment in EU-15 in the period 1991-2002. Although in this period in EU-15 countries larger adjustment was made on the revenue side, including temporary measures, expenditure based adjustments proved to be more successful.

Taking a look at individual expenditure categories in Slovenia in the period after 1992, one can see that social security transfers comprise the largest part in the expenditure structure. In addition, this has been the fastest growing expenditure item in the period shown along with growth of expenditure on wages, which is also high by international standards. While social security transfers increased most in the first part of the period, especially in 1993 and 1994, wages have contributed most to the increase in the expenditure ratio from 1995-1997 and again in 2001.

Chart 2: Composition of expenditure, 1992-2003 (in % of GDP).



Source: Ministry of Finance of the Republic of Slovenia.

Investment spending, which is seen as politically the easiest way to cut expenditure, has been relatively stable in this period at around 4% of GDP, with the exception of the first two years. Interest spending has grown due to the growth in debt, but is relatively small in

<sup>3</sup> Their sample consists of eight new European Union Member States from Central and Eastern Europe plus Bulgaria and Romania for the period 1991-2003.

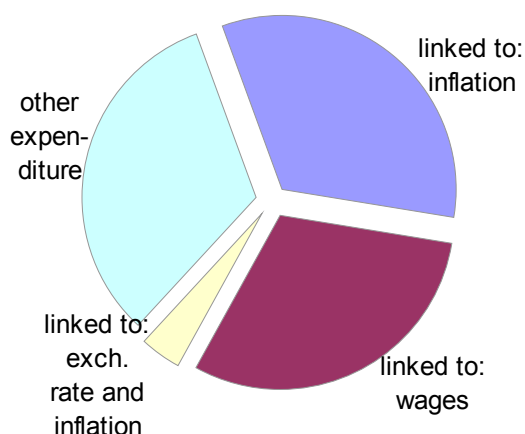
Slovenia, as public debt is among the lowest in the European Union<sup>4</sup>. Some further data on general government expenditure, based on ESA 95 methodology, is provided in appendix I<sup>5</sup>.

### *Non-flexibility of expenditure*

In Slovenia a large proportion of expenditure is »fixed« or mandatory, meaning that it is extremely difficult to change, as this would in most cases require changes to the law. According to some estimates, roughly 80% of expenditure is fixed (mandatory) or relatively fixed, so the ability of the government to react to unfavourable revenue developments is quite limited.

It is hard to define, which expenditure items can be treated as mandatory. Nevertheless, one can treat expenditure on wages, different social benefits, interest payments and a large part of expenditure on goods and services as fixed or relatively fixed.

Chart 3: "Fixity" of expenditure (2002).



Source: Author's estimates.

The above chart shows that in Slovenia – even more in the past, but still today – a large proportion of expenditure is linked (indexed) to different macro-economic categories. Although the shares shown are very rough estimates, they indicate that a large amount of expenditure is fixed in advance (although related to specific macro-economic aggregates). Later the progress made in this respect will be discussed.

## 2. DEVELOPMENTS IN INDIVIDUAL EXPENDITURE CATEGORIES

In this part we discuss past developments in the most important expenditure categories, along with their current issues and, where relevant, medium- to long-term prospects.

<sup>4</sup> Debt of the Republic of Slovenia amounted to 25.8% of GDP at the end of 2004, as measured by the national methodology. The debt of the general government sector, measured according to the ESA 95 methodology, stood at 29.4% of GDP.

<sup>5</sup> In table 1 general government expenditure by type is provided for Slovenia for the period 2000-2004. In table 2 general government expenditure by type is compared with other EU-25 countries. Additionally, table 3 provides data on general government expenditure by function for some EU-25 countries.

We concentrate our analysis on wage expenditure and transfer payments, as these are the groups that exerted the most pressure on expenditure growth in the past, and because additional pressure is expected from transfer payments in the future. Less attention is given to other categories.

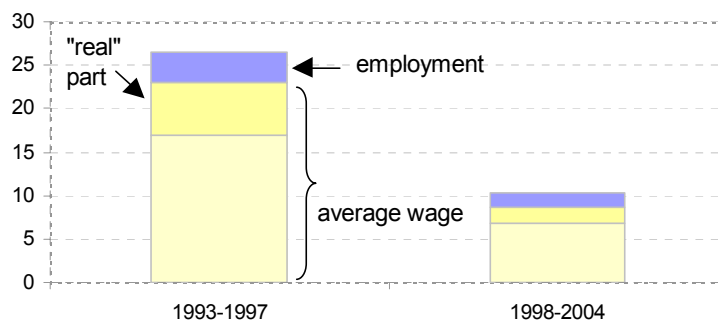
### 2.1. Wage expenditure

Wage expenditure accounted for between 9.5 to 10% of GDP in the period of 2001 to 2003, and was substantially higher than in the first part of the 90s (around 8.5% of GDP in the first two years of the observed period). This makes wage expenditure one of the two fastest growing expenditure items in Slovenia. Increases in average wages as well as employment growth contributed to this result.

Employment in the general government sector increased by a third from 1992 to 2004, comprising now more than a fifth of the total employment, and real wages in the public sector have increased by 50% in the same period. The growth of wage expenditure was especially high in the initial years up to 1997, when not only average (real) wages increased substantially, but also employment. Thereafter, the growth in general government sector real wages decelerated and was very low after 2002, with negative growth posted in 2004<sup>6</sup>.

The level of wages in the public sector<sup>7</sup> is currently on average about 34% higher than in the private sector. This comparison may be problematic due to the composition of total remuneration between wages and fringe benefits and due to differences in the level of education between the two sectors. Nevertheless it can be observed that public sector wages are relatively high in Slovenia, which is not the case in many European Union countries. In his study of public sector wages Bole (2001) concludes that in Slovenia relative wages are too high.

Chart 4: Growth of wage expenditure, 1993-2004 (annual averages, in %).



Source: Author's calculations.

The growth in employment also contributed significantly to the growth in wage expenditure, and thus exacerbated pressures on expenditure. The largest increase has been in public administration. Altogether this indicates that government employment policy has been rather lax. The government plans to apply stricter employment policy in the following years.

<sup>6</sup> However, public sector employees have been receiving payments for the collective voluntary pension insurance with effect from August 2003.

<sup>7</sup> Wages in the public sector depend on the wage class, working time, and to a small extent, on bonuses.

In the recent period, moderation in the average general government wage increase contributed to tighter control over general government wage expenditure. This was achieved by changes in wage indexation. The adjustment mechanism for 2004 was based on projected (rather than past) growth of consumer goods prices in Slovenia (excluding alcohol and tobacco), projected consumer goods prices in the European Union and the projected growth in the exchange rate of the tolar against the euro. A similar adjustment mechanism, taking into account the first two elements mentioned above is in place also in 2005 and could be renegotiated thereafter. An increase in individual general government wages of 2.5% is expected according to the adjustment mechanism in July this year.

The average general government sector wage declined in 2004 by 0.7% in real terms. Except in education, where wages are the lowest and are being increased in line with the special agreement over some recent years, other sectors showed a decline in average wages. This is the consequence of the following two reasons:

- a new adjustment mechanism incorporated into the agreement regulating wages in 2004, which is also valid for 2005 and
- the fact that wages in August 2003 were not increased, as agreed before, but instead voluntary pension insurance was introduced for general government employees.

Restraining the growth in public sector wage expenditure has been set as an important priority for the future. While progress has been made in terms of increases in individual wage settlements, there should be greater restraint in the form of a more prudent employment policy.

## *2.2. Transfer payments*

Social protection in general is well developed in Slovenia. The indicator at-risk-of-poverty rate after social transfers stands at around 11%. This is a share of people with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised income. The same indicator stood at 15% in the EU-15 in 2000.

Along with wage expenditure, transfer payments contributed most to the increase in general government expenditure. The social welfare system has played an extremely important role in the transition process. We will show such development in the past and discuss which items increased the most, as developments within the group of transfer payments have been quite diverse.

Data show that expenditure on social protection in Slovenia is very close to the EU-15 level, when expressed in terms of GDP shares. Also, the division between the most important categories is very similar. The highest share is spent on old age and survivors pensions. It is followed by sickness/health care expenditure, which in Slovenia is a slightly larger proportion of social security expenditure than in the European Union. However, the reverse is the case for unemployment payments. Social benefits are mainly determined by law, which determines beneficiaries and their entitlements. The fact that social transfers are large and institutionalised, however, sets some limits on the design of fiscal policy measures.

Some types of expenditure require an assessment of their long-term sustainability, as short- and medium-term movements may mask their 'true' development. Typical examples of where long-term sustainability should be considered are public pension schemes and health expenditure. Analysis of these two items is especially warranted due to their large amounts. We will show that the burden of pensions increased in the early stages as a result of transition (in the form of favourable early retirement schemes to prevent high

unemployment). This was placed on firmer foundations following the pension reform in 2000, which resulted in a gradual reduction of the financial burden of pensions on the economy. In future, as elsewhere in Europe, demographic developments are expected to cause additional significant financial pressures.

*Table 1: Social benefits by function, 2001<sup>8</sup>.*

	EU-15	Slovenia
<b>Total (in % of GDP)</b>	<b>27.5</b>	<b>25.6</b>
Structure (in % of total)		
Old age and survivors	46.0	45.5
Sickness/health care	28.2	31.4
Disability	8.0	8.7
Family/children	8.0	8.9
Unemployment	6.2	3.7
Housing and social exclusion	3.6	1.8

Source: Eurostat, Statistics in Focus Theme 3 - 6/2004.

### *2.2.1. Pension expenditure*

Social security in Slovenia has a long tradition, and pensions constitute the most important transfer of payments to households, accounting for around 11% of GDP. The system is characterised by a high dependency rate, and a relatively high replacement ratio, which was even higher in the past. Slovenia is one of the European Union countries, who spend high share of GDP on pensions<sup>9</sup>. Major pension reform was introduced in 2000 and may be seen as a major success in the field of expenditure policy, as it greatly contributed to improving financial viability of the system and decreasing the size of implicit debt. All major expenditure-cutting measures have been employed.

In what follows we will explain the basic features of the Slovene pension system, the reform in 2000, its results, and possible future trends.

#### *The Slovenian pension system*

Slovenia has a defined benefit pay-as-you-go (PAYG) pension system. In such a system, benefits accruing to the current beneficiaries are financed by current contributions, and usually also by a substantial amount of budget transfers. There is no close relationship between an individual's contributions and benefits, as is characteristic of fully funded schemes. Benefits in a Slovenian PAYG system depend on the person's earnings history and contribution period. Eligibility for pension benefits is determined by a statutory retirement age and a minimum contribution period.

Contributions are paid by both employers and employees in Slovenia, with special arrangements for farmers and the self-employed. Contributions paid by an individual are defined as a proportion of gross salary. For some segments of the population, special –

<sup>8</sup> While comparing this data to the data presented in table 3 in appendix I, take into account that social benefits here include health expenditure, while in the Classification of the functions of government (COFOG) health expenditure is recorded separately.

<sup>9</sup> The highest expenditure on pensions is found in Italy, where 14.7% of GDP was spent on pensions in 2001 and the lowest in Ireland with expenditure amounting to only 3.7% of GDP (Statistics in focus, 8/2004).



more favourable – arrangements are defined by law (casualties of war and war veterans, police, farmers, mine workers, the self-employed). The central government funds the pension system for pensions paid on the basis of these special eligibility criteria. Pension benefits are subject to personal income tax and health care contributions.

Pensions have a floor and a ceiling. Old-age pensioners that do not receive a full pension are entitled to a means-tested income supplement.

*Table 2: Revenue, expenditure and balance of the Pension Fund, 1992-2004.*

in % of GDP	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
<b>Revenue</b>	<b>12,6</b>	<b>13,5</b>	<b>13,2</b>	<b>13,0</b>	<b>12,9</b>	<b>13,2</b>	<b>13,6</b>	<b>13,4</b>	<b>13,5</b>	<b>13,8</b>	<b>13,8</b>	<b>13,7</b>	<b>13,5</b>
Contributions	11,4	12,6	12,0	11,9	10,2	9,3	9,3	9,2	9,4	9,5	9,3	9,4	9,3
Transfers from state budget	0,0	0,5	0,9	0,9	2,6	3,7	4,0	4,0	3,7	4,0	4,2	4,1	4,0
Other	1,2	0,5	0,3	0,2	0,2	0,2	0,2	0,2	0,4	0,3	0,3	0,2	0,2
<b>Expenditure</b>	<b>12,9</b>	<b>13,2</b>	<b>13,5</b>	<b>13,7</b>	<b>13,6</b>	<b>13,5</b>	<b>13,5</b>	<b>13,6</b>	<b>13,8</b>	<b>13,8</b>	<b>13,8</b>	<b>13,6</b>	<b>13,4</b>
Pensions	10,7	11,0	11,4	11,5	11,4	11,3	11,3	11,4	11,5	11,4	11,3	11,2	11,0
Old age pensions	6,5	6,8	6,9	7,0	6,9	6,9	6,9	7,0	7,1	7,1	7,1	7,1	7,0
Other expenditure	2,2	2,1	2,1	2,2	2,2	2,1	2,2	2,2	2,3	2,4	2,5	2,5	2,4
<b>Balance</b>	<b>-0,3</b>	<b>0,4</b>	<b>-0,3</b>	<b>-0,7</b>	<b>-0,6</b>	<b>-0,3</b>	<b>0,1</b>	<b>-0,2</b>	<b>-0,3</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,1</b>
<b>Balance without transfer</b>	<b>-0,3</b>	<b>-0,1</b>	<b>-1,2</b>	<b>-1,6</b>	<b>-3,2</b>	<b>-4,0</b>	<b>-3,9</b>	<b>-4,2</b>	<b>-4,0</b>	<b>-4,0</b>	<b>-4,2</b>	<b>-4,0</b>	<b>-3,9</b>

Source: Ministry of finance of the Republic of Slovenia.

The Pension Fund currently receives transfers reaching some 4% of GDP per annum from the central budget, which can be interpreted as a sign of already present financial stress. There are two types of transfers:

1. to cover legal obligations based on various laws, already mentioned above (pensions for war veterans, military pensions)<sup>10</sup> and
2. to cover the remaining deficit of the Pension Fund (deficit of revenues)

PAYG schemes have to be assessed in terms of future economic and demographic prospects. An assessment of these for the case of Slovenia is given below.

### *The early 1990s*

The sustainability of the system worsened markedly at the beginning of the 1990s, when a substantial fall in the ratio of contributors to the pensioners (beneficiaries) occurred. This was caused by the generous early retirement schemes introduced in order to deal with the problems caused by the sharp decline in GDP and enterprise restructuring as a consequence of losing the Yugoslav market. Demographic reasons were not part of the problem at that time.

Due to early retirement schemes, the number of pensioners increased. Early retirement provisions were available to people who became unemployed due to a company going bankrupt, those who were unemployed for the previous two years, and those who were partially disabled. For these groups the pension eligibility criteria were relaxed and they were entitled to receive a pension at the usual age limit, but with five fewer contribution years. The replacement rate was only slightly lower (1% deduction per missing year on the pension base) and adjusted (that is reduced) just until the time when the person reached regular retirement age. During 1991-1992, early retirement could be taken at 55.5 years for men and

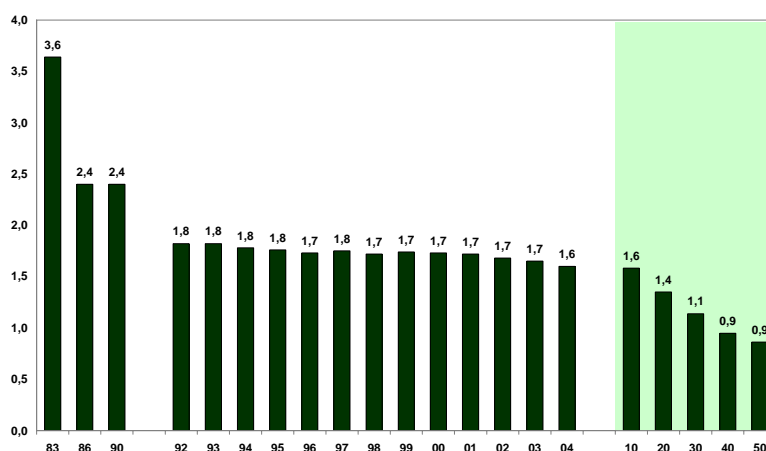
<sup>10</sup> In 2003 these amounted to 1.4% of GDP. This is an indication of budget allocations for the more favourable treatment of specific groups.

50.5 for women, with 35 and 30 years of insurance contributions, instead of the required 40 and 35 years, respectively.

The number of early retirement pensioners mainly increased in the early 1990s, peaking in 1992, when they represented some 13% of old age pensioners. We estimate the spending on early retirement in those years at around 0.8% of GDP, or alternatively at around 6% of Pension Fund expenditure.

At the same time the number of contributors declined substantially, which resulted in a very unfavourable development in the support ratio.

Chart 5: Support ratio (1983-2050).



Source: Pension Fund and author's calculations.

For the beginning of the 90's the Pension and Disability Insurance Act of July 1983 has been an important legal act. This law treated pensions as remuneration for active labour participation in the past and introduced an indexation rule which was no longer based on the cost of living, but rather on wage growth. This Act also broadened the scope of various non-pension benefits, such as pension income supplement for those with low pensions (Stanovnik, 2002).

In 1992 a new pension law was passed (the so-called minor pension reform), which did not bring very substantial changes. Eligibility requirements were tightened; a gradual increase in the required retirement age was introduced, in total by 3 years. Reversing the preceding legislation, the age condition was re-instated. Beforehand, pension entitlement fell to anyone meeting the criteria of 40 and 35 years of qualifying period, men and women, respectively, regardless of the age. After 1992 the required age increased gradually from 55.5 years in 1992 to 58 years in 1998 for men; and from 50.5 years to 53 years for women. Actual retirement age increased only slightly and was close to the statutory minimum age criterion. The reform in 1992 somewhat increased the inclusion of certain groups of people in insurance, for example, the unemployed receiving unemployment benefits.

#### *Basic features of the pension reform in 2000*

Comprehensive pension reform was implemented in 2000, after adopting the Pension and Disability Insurance Act a year before. It was a parametric reform, which complemented PAYG with a voluntary private pillar. Changes introduced in the first pillar were substantial, but are being implemented gradually. The transition to the new system is not yet complete,

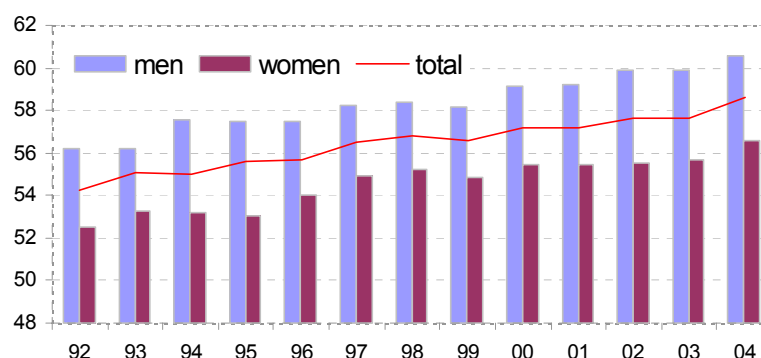
and will be only finalised in 2025. The initial reform proposal was even more radical, with the intention of introducing a mandatory privately fully funded second pillar. Finally, only a voluntary second pillar was introduced, which is subject to favourable tax treatment.

In the first pillar, Slovenia has introduced a standard list of expenditure reducing measures. The three main parametric adjustments introduced to the pension system include:

- a gradual increase in the retirement age,
- a gradual decline of replacement rates and
- a change in the indexation formula which caused the growth of pensions to lag behind wages.

The first element has been an increase in the statutory retirement age. It was set at 61 years for women (up from 53), and 63 years for men (up from 58) and will be phased in over a number of years. The transition will be completed in 2008. The earliest retirement age is 58, in the case of those meeting the 40 and 38 year qualifying period<sup>11</sup>, for men and women respectively. The retirement age can be reduced progressively for persons with children<sup>12</sup>. Also, in this case, retirement before 58 is not possible. This change will be introduced gradually by 2015. These changes will reduce the growth in the number of beneficiaries.

Chart 6: Average retirement age, 1992-2004



Source: Pension Fund.

Following both reforms, the average retirement age began to increase, while the ratio of average old age pensions to average wages began to decrease. After 2000, the effective retirement age increased by an average of around 5 months per year. In 2004 the average age at retirement for new old age pensioners was 60 years and 7 months for men, and 56 years and 7 months for women, an average of 58 years and 7 months for the whole population of new retirees.

Second, the replacement ratio fell, and as a consequence the benefits were reduced. Before the reform the accrual rate was set at 85% of the pension base, but after the reform it has been declining gradually. At the end of transformation period, e.g. by 2025, it will have been reduced to 72.5% for men and 68% for women for full career workers. The benefit

<sup>11</sup> Pension qualifying period includes (i) time a person has been insured and has been paying contributions, (ii) periods, which qualify, but no contributions have been paid and (iii) years "purchased" (time at the university for example).

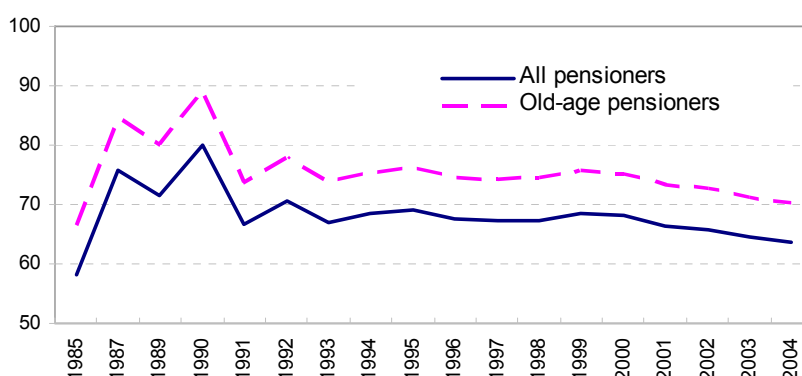
<sup>12</sup> For one child by 8 months, for two by 20 months, for three by 36 months and for each additional child by another 20 months.

assessment period will be increased from 10 years to 18 years<sup>13</sup> by 2008, when it will be fully adjusted to the new regulations.

The revised pension system allows for flexible retirement, making it possible when at least the minimum pensionable age is reached. Early retirement is available for those aged 61 and older, if they have contributed at least 30 years. However, the replacement rate is adjusted and remains in place indefinitely. This contrasts with the previous regulations, when the replacement rate in the case of early retirement increased after person had reached a certain age.

The ratio of the average old age pension to the average wage was very high at the beginning of the 1990s, reaching a high of 90% in 1990. This meant a good relative income position for pensioners<sup>14</sup>. It decreased thereafter, reaching a value of 75.8% in 1999, a year prior to the latest pension reform. It declined thereafter, to 70.2% in 2004. Expenditure on pensions decreased from 11.4% of GDP in 1999 to 11.0% of GDP in 2004.

Chart 7: Average replacement rate, 1985-2004.



Source: Pension Fund.

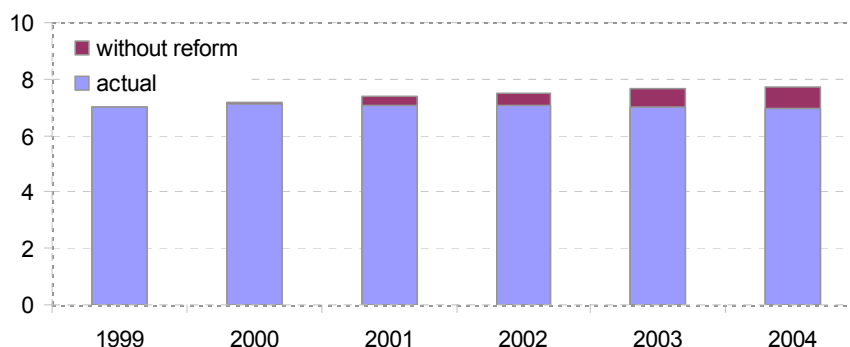
The third element, and the most important in terms of increasing long-term sustainability, was the change in the indexation method. Pension benefits and past contributions are adjusted annually, reflecting wage developments. The new system retained the link between pensions and wages, but in a way that guarantees slower growth of pensions<sup>15</sup>. Another important innovation was that the law introduced a downward adjustment of pensions for those who had retired in previous years, and by doing so equalised their position with new entrants who had retired under less favourable terms. In the years after the reform (e.g. from 2000 to 2004), the available data point to pension adjustments lagging behind wage growth.

All these changes created savings on pension expenditure in the period after the introduction of the reform. This can also be illustrated by the fact that in this period expenditure on old-age pensions did not increase as a proportion of GDP, being around 7% of GDP in 2004, the same as in 1999. At the same time the number of persons aged 60 years and more increased. Estimates of the savings due to the reform are shown in *chart 8*.

<sup>13</sup> Calculations made by Pension fund have shown that a transition to best twenty year period instead of best ten year period would result in an old age pensions lower by some 10% (Stanovnik, Kukar, 1995).

<sup>14</sup> Calculations show that the system was generous in terms of benefits. There is only a weak link of contributions to benefits as these are based on best earnings formula.

<sup>15</sup> This change has been introduced in 2001.

**Chart 8:** Effects of pension reform in 2000, expenditure on old-age pensions (in % of GDP)

Source: Pension Fund, author's calculations.

Pension systems are highly complex, and estimates of pension reform savings can be seen as indicative only. According to our estimation, the pension expenditure on old-age pensions would have been 7.7% of GDP in 2004 in the “no reform scenario”, some 0.8 percentage points more than the actual outcome. This can be ascribed to two elements of the reform:

- Changes in replacement level, which incorporate changes in the indexation mechanism: they account for the larger part of the change.
- An increase in the retirement age, which postponed retirement, a factor harder to estimate. According to our estimates, this contributed to almost half of the difference between the actual outcome and the “no reform scenario”.

The new pension law introduced yet another type of pension, the state pension. This is the right of a person aged 65 and over who is not entitled to a pension under “normal” conditions, and has no income or has an income lower than the state pension. The number of persons receiving this pension increased rapidly after the introduction and related expenditure now accounts for 0.1% of GDP. The amount of a state pension is currently set at around EUR 140 per month.

#### *Projection of possible future developments*

In this section we try to evaluate the possible effects of future demographic developments (presented in Annex II) on pension expenditure. Changes in the old-age dependency ratio provide a broad indicator of the pressures arising from demographic changes on social spending<sup>16</sup>. We have found that the pressure on pension expenditure due to ageing will increase, and that implicit liabilities on pensions are high.

Old-age benefits account for approximately half of the total expenditure of the Pension Fund, disability benefits 12% and survivors pensions some 10%<sup>17</sup>. Currently pension expenditure represents 10.9% of GDP, and other expenses of the Pension Fund (mainly social assistance benefits) to 2.5% of GDP; of this, 0.15% of GDP is spent on administrative costs.

<sup>16</sup> While these changes contribute to pressures on pensions and health outlays, expenditure on education is expected to be stable, or more probably, to decline in the next decades despite anticipated higher enrolment rates, especially at university level.

<sup>17</sup> Old-age pensions have a predominant share within total pensions and accounted for some two thirds of total pension expenditure in Slovenia and around three quarters in EU-15 in 2001. In the EU-15 share of disability pensions represented about one-tenth, and that of survivors' pensions somewhat lower proportion of the total pension expenditure (Statistics in focus, 8/2004).

Some calculations of the possible effect of future demographic developments on pensions are being presented in what follows, with only changes in old-age pensions being estimated. The macro-economic assumptions underlying our calculations are exogenously determined and presented in the table below.

*Table 3: Macro-economic assumptions, 2001-2050*

	2001-2050	2001-2010	2011-2020	2021-2030	2031-2040	2041-2050
Real GDP	1.9	3.6	2.6	1.9	1.0	0.5
Inflation	2.8	4.0	2.5	2.5	2.5	2.5
Employment	-0.5	0.5	-0.3	-0.8	-0.9	-1.3
Participation rate	72.4	68.1	70.2	72.3	74.5	76.8
Real interest rate	3.0	3.0	3.0	3.0	3.0	3.0

Source: Author's calculations.

Projected labour productivity growth (real GDP per person employed) is assumed to gradually converge from 3.7% in 2005 to 3% in 2015, to around 2% in 2030, and to 1.8% from 2040 on due to closing the gap with more advanced economies. Taking these assumptions into consideration, real GDP growth for the whole period is set at 1.9% on average.

The labour force in the next two decades is largely given by past fertility. To a lesser extent, it is influenced by the assumption of increasing participation rate. Employment growth is negative due to a decline in population, in particular, the population of working age people. An increased participation rate implies a reduction in the unemployment rate. CPI inflation is held constant at 2.5% throughout the projection period.

Two indicators are important in projections of the Pension Fund position: the support ratio and the replacement ratio. In our projections the former is mainly effected by demographic changes (also by the macro environment), while the latter depends mainly on the changes introduced in 2000 by the new Pension and Disability Insurance Act. In the projections, standard practice is followed and therefore non old-age pension related expenditure and revenue not connected to contributions is kept at 2004 levels for the whole period.

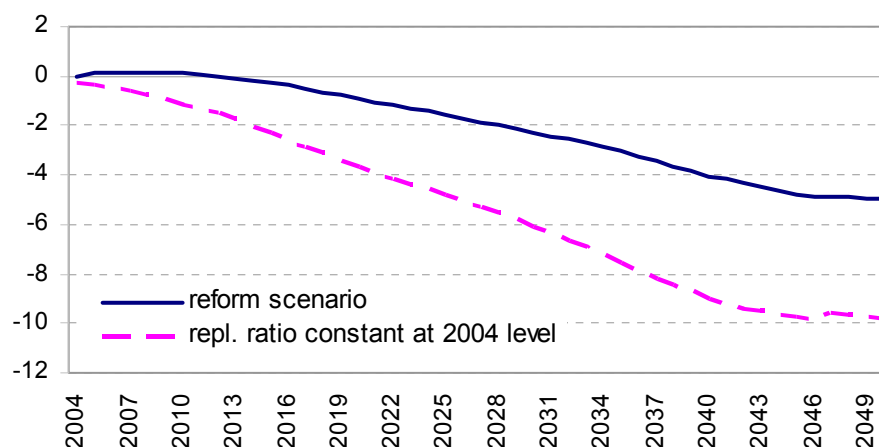
*Table 4: Replacement and support ratio, 1995-2050*

	1995	2000	2005	2010	2020	2030	2040	2050
Replacement ratio	69,2	68,1	62,8	59,0	52,4	48,8	46,9	45,2
Support ratio	1,76	1,73	1,65	1,58	1,35	1,14	0,95	0,86

Source: Pension Fund, Author's calculations.

Simulations show that the replacement rate of pensions will have decreased to less than 50% by 2030, mainly due to changes in the indexation of pensions. Low replacement rate can be a cause of concern in itself, as it raises questions concerning the social welfare of pensioners.

Chart 9: Projected Pension Fund deficit in % of GDP



Source: Author's estimates.

According to our calculations the deficit of the Pension Fund would reach around 5% by 2050. Projections include the effects of pension reform, which are, however, difficult to estimate due to complexity of the pension system. The financial impact of population ageing will start to accelerate quickly at around 2015. These calculations should be treated with caution, as they are subject to uncertainties regarding demographic developments, as well as macro-economic assumptions.

Should the replacement rate remain constant at the level reached in 2004 (63.7%), the results would be substantially worse. According to our estimates, the deficit would double by the end of the projection period, as would unfunded public pension liabilities, e.g. implicit debt.

We can conclude that the pension reform has been successful from the public finance point of view, as the burden of pensions has been substantially reduced. Nevertheless, this means that pensioners taking retirement in the coming decades will need additional financing. In Slovenia there is no mandatory, privately managed, fully funded system in addition to PAYG. However, voluntary pension insurance has been developed to some extent and after five years, just over half of the persons included in the compulsory system has also arranged for additional pension insurance. The number increased substantially in 2003, when public sector employees entered the system. This will provide an important additional source of income in retirement and help to keep pensions at an adequate and sustainable level, thus avoiding substantial increases in poverty rates among the elderly. However at this point it is difficult to estimate if this will be enough. Calculations presented also imply the need for additional measures to improve long-term sustainability of the Pension Fund. The uncertainties surrounding such calculations should, however, be taken into account as well.

### *Current issues*

Three main issues arise from our discussion:

- First, according to our results, additional changes will be needed in the future to improve the sustainability of the PAYG system. This can be done by further parametric changes of the system. There are many possibilities, for example additional prolongation of benefit assessment period and changes to the statutory retirement age.

- The second issue that should be mentioned is the need for more equal treatment of various groups of people. For example, the self-employed are now able to choose their contribution rate and basis for pensions.
- The third issue is further development of funded pension schemes, which would provide enough financing in addition to what people would receive from PAYG. This is essential in order to lessen the risk of poverty in old age.

### 2.2.2 Health expenditure

Slovenia faces similar problems in health care financing as other (comparable) countries. The main issue in the health care systems of these economies is that demand for services is usually greater than the system is capable of providing. It is widely recognised that the pressures for increased health expenditure are due to:

- population ageing,
- the development of new and more expensive diagnostic tests, new methods of treatment and more expensive medicines and
- better informed patients, who require access to new forms of health care.

Health expenditure in Slovenia appears to have stabilised at around 8.5% of GDP, which is comparable to the selected European Union countries shown in the table below. Slovenia's health care indicators are generally also comparable to those in the selected countries. While on one hand the infant and child mortality show favourable outcomes, developments in maternal mortality are more of a concern. Male life expectancy proves worse in comparison with that of females. Slovenia's ratio of 2.2 physicians per 1000 population is lower than in other countries. Also, the number of hospital beds per 1000 population is at the lower end of the scale.

Table 5: Health indicators, 2001.

	Slovenia	Austria	Czech R.	France	Germany	Hungary	Italy	Portugal	Spain
Life expectancy at birth, females	79,5	81,8	78,8	82,9	81,1	76,1	82,2	80,1	82,6
Life expectancy at birth, males	72,1	75,9	71,9	75,6	75,1	67,3	76,2	72,7	75,3
Lost healthy years at birth, females	9,2	8,8	9,3	9,5	8,9	10,5	9,3	10,7	9,6
Lost healthy years at birth, males	7,0	7,0	8,1	6,6	6,8	9,3	7,0	8,5	6,6
Healthy life expectancy at age 60, females	16,6	18,5	16	19,1	17,7	14,4	18,2	16,2	18,2
Healthy life expectancy at age 60, males	13,3	15,7	12,8	16,1	15	10,5	15,5	13,4	15,2
health expenditure (% of GDP)	8,4	8,0	7,4	9,6	8,9	6,8	8,4	9,2	7,5
(% of exp)	14,6	10,7	14,1	13,7	16,6	11,5	13	13,7	13,6
share of public exp.	74,9	69,3	91,4	76	74,9	75	75,3	69	71,4
Per capita exp. On health in int. dollars	1.545	2.259	1.129	1.951	2.113	686	1.660	1.116	1.607
infant mortality rate (per 1000 births) *	5	5	4	5	4	9	5	6	4
child mortality rate (per 1000 births) *	6	6	5	6	5	11	6	7	6
maternal mortality rate (per 100.000 births) *	17	5	9	17	9	11	5	8	5
physicians per 1000 pop. **	2,2	3,4	3,5	3,3	3,4	3,2	6,2	3,2	3,0
hospital beds per 1000 **	5,0	8,3	8,6	7,8	8,9	7,8	4,1	3,2	3,6

Sources: OECD Health Data 2004 and World Health Organisation , Core Health Indicators 2004, WHO Health for all database.

\* data for 2000 \*\* mostly data for 2002.

### Basic features of the health reform in 1992

In Slovenia, health expenditure was part of an integral budget up to 1992. No extra payments were necessary for health care, as the budget provided full coverage to all citizens. However, in the early 1990s, the financial burden of health financing proved too high. Therefore, reform was needed. In February 1992, a new law on health care and health



insurance was passed which established the current health care financing system: a combination of obligatory health insurance and voluntary health insurance, accompanied by out-of-pocket payments. Social security contribution rates for health care were determined, and the Institute of Health Insurance was established to manage public sources from obligatory health contributions and to provide the financing of health care expenditure. Compulsory health insurance covers almost all citizens. Insurance benefits cover payments for health services, sickness payments for absences from work exceeding 30 days, and other, minor expenses (for example, travel costs related to the use of health services).

Health reform resulted in an increased role played by the private financing of the health expenditure, whereas previously the health sector had been financed almost entirely from public sources. In Slovenia, approximately 8.5% of GDP is currently spent on health care, most of which – some three quarters – is financed from compulsory health insurance. In the last 5 years the share of GDP spent on health care increased by 0.5 percentage points. Voluntary health insurance covers about 1% of GDP of health expenditure, which is about one-seventh of what is paid from public sources. There are also other payments out of pocket, which represent lower shares, but nevertheless amount to almost 0.8% of GDP.

The basket of benefits covered from public sources has been defined and has not been changed substantially. It basically covers two different types of rights:

- payment of medical services, medicines and other medical materials (in total or to a certain percentage) and
- various payments - for example sick leave compensation: these payments gained importance after the reform.

A basket of benefits, including basic general and specialist treatment in hospitals, along with pharmaceuticals and medical materials, is currently covered by social security contributions and insurance premium<sup>18</sup>. Co-payments are rare only for those who pay additional voluntary health care premiums and cover the area of dental services, pharmaceuticals, and orthopaedic devices. Consequently, very soon after the reform, most of the population opted for additional voluntary health insurance (at present, 92% of the population is covered). This was the consequence of the fact that a lot of health services require cost sharing, and insurance against substantial co-payments in case of illness is provided by supplementary insurance.

The level of services is decided by negotiation among the interested parties. The volume of services, which will be paid out of compulsory health insurance is decided for each year. Such an arrangement represents to some extent some constraint on health spending, but on the other hand, has resulted in increased waiting lists, which are a sign of excess demand for services.

Pharmaceuticals are classified into three lists:

- a 'positive' list of drugs that are fully reimbursed through compulsory insurance,
- a 'mixed' or 'intermediate' list, where part of the burden is covered through compulsory insurance and
- a 'negative' list of drugs that are not reimbursed through insurance arrangements.

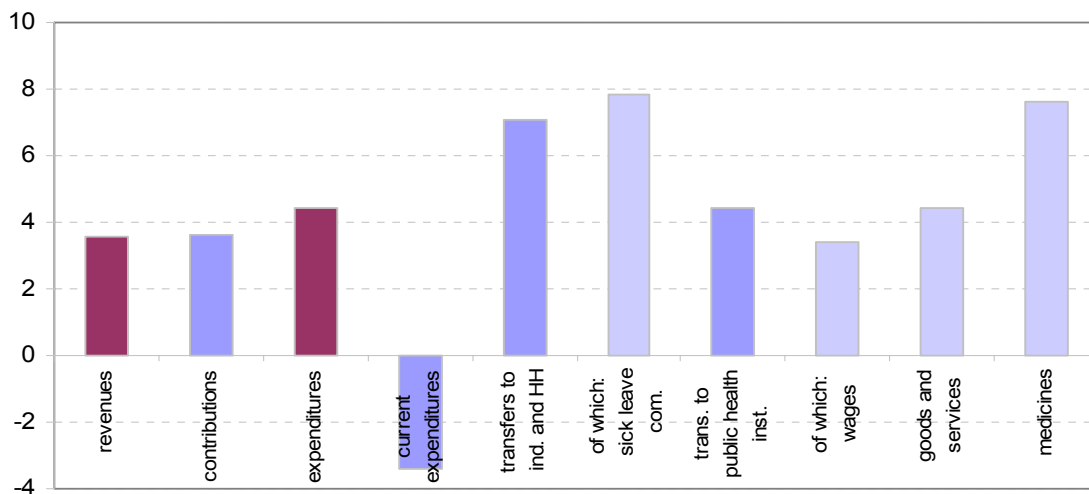
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<sup>18</sup> Some services are covered in total from public sources for insured persons and some other specified groups. These include, for example: medical treatment of children and students, urgent first aid, compulsory vaccination, medical treatment and rehabilitation as a consequence of occupational disease or injuries at work, medical treatment for pregnant women, and obstetrics. Other services are paid out of public sources up to a certain percentage. This percentage varies considerably: from 25% (some medicines) to 95% (medical treatment abroad, dialysis).

In general, after 1992 the regulation was to pay hospitals a flat rate per hospital day or inpatient care by the Institute for Health Insurance. Payment to hospitals primarily on the basis of the number of hospital days created an incentive for excessive lengths of stay. Local governments are responsible for financing the physical infrastructure of local systems of primary health care.

Health care expenditure increased by 48% in real terms from 1993 to 2003. The greatest part of expenditure is on the financing of health care services (hospitals, physicians, materials used), while at the same time employees are entitled to sick leave payments and some other types of cash payments. High growth in wages in 1996, the introduction of VAT, and expenditure on medicines, which increased by 67% in real terms in the same period, are the main reasons behind the high growth in expenditure. In addition to expenditure on medicine, expenditure on sick leave compensation benefits also greatly increased.

*Chart 10: Revenue and expenditure of Institute of Health Insurance, average real growth rate per year, 1999-2003.*



Source: Institute of Health Insurance.

*Chart 10* shows that in the last five years expenditure has grown faster than revenue, and has also been higher than GDP growth. While revenue increased by 3.5% each year, expenditure grew by almost one percentage point more.

Expenditure on medicines has been growing fast in all economies, and Slovenia is no exception to this trend. Expenditure on medicine represented 14% of expenditure of the Institute of Health Insurance in 2003, while it accounted for 12.3% in 1993. However, this does not reflect the total growth of expenditure on medicines, which was even higher. The compulsory health insurance rules regarding lists of pharmaceutical products have been changed. Pharmaceutical products that are paid for out of compulsory health insurance are classified on a 'positive' list (where 75% of costs are covered by the compulsory insurance) and an 'intermediate' list (where coverage is 25%). By changing the lists in the period following health reform, payments for medicines have been 'transferred' to some extent from obligatory to private health insurance.

The introduction of new medicines has produced the opposite effect, since they are usually much more expensive than those already on the lists of pharmaceutical products covered by

compulsory insurance. Due to high pressures on expenditure, measures to limit costs are constantly present in the system.

### *The proposed reform in 2003*

After the 1992 reform, the public health system enjoyed a surplus for some years, but later it was again not possible to fully cover health expenditure from available sources. In 2003 the Institute for Health Insurance showed a deficit for the fourth consecutive year. It was recognised that such a development would only intensify in the following years if no measures were taken. As a result, new health reform was proposed in a White Book on Health Care Reform published in the summer of 2003.

The 'White Book' stated six main goals of the reform:

- To promote equity in the collection of resources for health care: payment to be income-related, rather than based on individual risk.
- Use of resources according to patient needs: access to basic health care for all if needed. This includes some degree of protection against the financial consequences of falling ill.
- Better access to the health care system
- Development of a Total Quality System
- Improved efficiency in the regulation and management of the health system
- Strengthening the area of public health

A major change in health financing was proposed - to abandon the voluntary health insurance and, instead, increase compulsory contributions. This would result in a greater amount of public resources being spent on health care, but this was strongly opposed and therefore did not materialise.

The reform proposals also covered issues related to the inefficiency of the health care system, such as deficiencies in the running of hospitals, insufficient use of primary and preventive care and the remuneration structure, which does not reflect performance, management of labour and physical resources in hospitals and the like.

Looking at expenditure issues, the authors of the "White Book" claimed that an additional 700 doctors and 1000 nurses were needed in Slovenia. Additional recruitment will put pressure on expenditure in the coming years, when staff numbers increase.

Despite the fact that some suggestions of the reform were highly criticised in the public and that a final agreement on the reform package was not reached, some changes were introduced to limit expenditure growth and to improve the financial viability of the system:

- First, a system of mutually interchangeable medicines and a list of highest recognised prices, which is a kind of benchmarking system, were introduced in November 2003. The first measure identifies those medicines that can be treated as "equal", as they are recognised as having the same or very similar effects. The second part of the measure was to set the highest price for a given group of medicines which are treated as having the same effects. By taking this measure, expenditure on medicines could be limited, but not stopped. The prices of medicines dropped after this measures were taken (for example, in November 2003 by 3.1%, in April 2004 by 0.6%), but still expenditure on other medicines, for example, those newly introduced on the lists, can continue to demand consistently larger amounts of resources. Long-term control of this form of expenditure will require continuous regulation of pharmaceutical prices combined with

stimulation for rational use; estimates by the Institute for Health Insurance show that some 10% of expenditure on medicines is unnecessary.

- Second, in the field of hospital financing the Diagnosis Related Groups system was introduced, which tackled the problems of the 'old' financing system. A group type payment system has proved to be a potentially effective means of improving hospital efficiency in some countries (Girouard, Imai, 2000). Payment is based on the expected (or average) cost of treatment of the patient (662 different diagnoses are possible<sup>19</sup>), rather than on actual costs. More complex treatment is valued higher. This provides incentives to make better use of resources (for example, by reducing lengths of stay in hospital), but may also lead hospitals to put patients into more 'expensive' diagnostic groups. The goal of this system is to pay hospitals more in line with work done (financial flow to follow the patients). Additionally, the financial savings of such measures may take years to materialise.
- Third, a centralised purchasing system (by means of tenders) for medical equipment and certain drugs can also bring substantial savings due to economies of scale. The health sector is an important purchaser of goods and services, and empirical studies show that competitive tendering results in lower costs in comparison to uncontested public provisioning, with possible savings estimated in the 10-30% range. However, these savings will most probably show up in the accounts of health institutions, not in those of the Institute for Health Insurance (Toth, 2003).

#### *Possible future developments*

Expenditure on health is sensitive to demographic developments. As older age groups have much higher rates of spending p.c. for health care, the ageing of the population will represent a continuing source of upward pressure on health care costs and expenditure. Estimates show that people aged over 65 consume on average four times as much health care as those below 65 (Oxley, MacFarlan, 1994). This factor alone can cause substantial increases in health expenditure in economies facing population ageing. A mechanical application of this ratio is questionable, however, as one can argue that lengthening of lifetimes means moving these expenditure further into the future (higher age). Some calculations show that from 2000 to 2020, health spending may grow by around 0.4% to 0.7% of GDP due to ageing, and by a similar amount from 2020 to 2040 (Oxley, MacFarlan, 1994).

For Slovenia, estimates of possible future pressure on health expenditure were made by the Ministry of Finance and published in the Updated Convergence Programme in January 2005. Taking these estimates into account, expenditure on health would increase by almost 3 percentage points up to 2050, being more pronounced after 2020. This compares to a 3-3.5 percentage point increase on average over the period 2000-2050 estimated for 19 OECD countries (Casey et al, 2003). However, these calculations must be treated with caution. It is well known that a large proportion of health expenditure is linked to the last years of life. If this is the major factor, then lengthening lifetimes may finally even postpone an increase in health expenditure.

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<sup>19</sup> Before there were only 10 different types of patient treatment, according to the field of treatment (surgery, gynaecology, etc.), which were valued differently.

## Current issues

The Institute of Health Insurance has operated at a deficit for the fifth consecutive year in 2004, registering a relatively small deficit of up to 0.2% of GDP in most of these years. The accumulated debt at the end of 2004 amounted to 0.5% of GDP, and will be taken over by the central budget in July 2005. After this transfer, the Institute for Health Insurance will be required to show balanced accounts.

In past years, the volume of health services as well as the definition of the basic health care package has not changed much. In the following years coverage of services will have to be reconsidered and priorities stated more clearly than at present. Some risks could be transferred out of compulsory insurance, for example, those related to extreme sports. The existing system, as in the case of pension insurance, gives some groups of people more favourable treatment: for comparably lower contributions they receive the same benefits. The measures described below can help relieve the pressure and the need for restraint in the volume of services offered.

The health system is not well managed, which is costly, and creates unnecessary waiting lists. Therefore, improvement in the management of the health sector and its efficiency is needed. This can produce substantial savings, better use of available equipment, an improved responsiveness of the system to the changing needs of the population, and should also result in shorter waiting lists. However, this is a matter of organisation of labour and the adequate use of available resources.

One of problems in the existing health care system is the high level of absenteeism. This is combined with a high level of sick leave payments, which in general reach 90% of wage in the first month, paid by the employer, and 80% thereafter, paid by the Institute of Health Insurance. If the leave is due to the illness of a child, benefit is also set at 80% and is paid entirely by the Institute of Health Insurance. In 2003, 4.7% of working days were lost due to sick leave, and sick leave payments amounted to 1.4% of GDP. The Institute of Health Insurance paid almost half of these payments, employers the rest.

Incentive problems should be dealt with. Free services increase the demand for health services. However, the goal of equity<sup>20</sup> must be respected. Consumers and providers of health services should be made more cost-conscious in order to put available resources to better use. At the same time, people with low incomes needing health care should not be discouraged from using the necessary health services. This means that the health system should be designed so as to assure access to the required health care to the people who are poor and getting sick.

The more cost-conscious policy on the use of pharmaceuticals should be implemented further. Various measures were implemented in the past, but costs have continued to rise. Currently, the goal is pursued by limiting the highest price of a medicine paid for from compulsory insurance.

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<sup>20</sup> Access to some predefined minimum level of health services should be made available to all citizens based on their need, not (only) income.

### 2.3. Unemployment benefits

In Slovenia, unemployment is to a large extent of a structural nature. A large proportion of unemployed are either long-term unemployed, first time entrants to the labour market and of old age.

The unemployment insurance system is seen as probably the weakest part of the whole social protection system by some and it is therefore concluded that it can not be seen as a generous one (Stanovnik, 2004). The system was more generous at the beginning of the 1990s, with publicly financed programs of unemployment benefits. On the other hand some others (Backe et. all) find that the level of unemployment benefits as measured by the replacement ratio<sup>21</sup> is relatively generous in Slovenia.

Expenditure on unemployment benefit has declined in the period under review. From 1992 to 2004 it fell by almost 1 percentage point of GDP and currently reaches about 0.3% of GDP. Currently, unemployment benefits account for 0.8% of total expenditure, down from 3% in 1992, when these payments were at their highest level. There are two important reasons for this. First, the economic situation has improved substantially compared to the early 1990s. The level of unemployment has decreased from a high of 9.1% in 1993, to 6.3% in 2004. Second, there has been a reform in the benefit system, and eligibility criteria for unemployment allowances have been tightened in 1998. One measure was the cancellation of extended unemployment payments (up to three years) on the assumption that the person could retire thereafter.

According to the law, unemployment benefit is paid from 3 to 24 months, depending on the insurance period. After this period, means-tested unemployment assistance benefit may be paid for 6 to 15 months.

In recent years more emphasis has been given to active labour policy measures, which however are limited, and intended for certain groups of unemployed people. The latest measures were intended to increase the participation of older workers and those entering the labour market after attaining certain education level. The Budget Implementation Act for 2004 and 2005 foresees the following measures:

- An employer who employs an unemployed person, aged 55 or more and registered with the Unemployment Office for a period of 2 years or more, will be exempt from paying social security contributions for this person for a period of one year. The measure was introduced due to the fact that in Slovenia the total employment rate of older workers<sup>22</sup> is one of the lowest in European Union, being close to 25% in 2002, while it reached 40% in EU-15. It is particularly low for females, which is related to fulfilment of retirement conditions.
- An employer who employs an unemployed person with a higher education, below the age of 26 and currently registered with the Unemployment Office for an indefinite period, will be exempt from paying social security contributions for this person for a period of two years. In Slovenia unemployment among first time job seekers is high, and this measure should help facilitate finding first employment.

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<sup>21</sup> It is defined as the initial benefit over previous earned income.

<sup>22</sup> Employed persons aged 55-64 as a share of the total population of the same age group.

#### 2.4. Other transfers to households

The most important transfers to households not mentioned above are comprised mainly of family and child benefits, as well as social support for categories of the population in need.

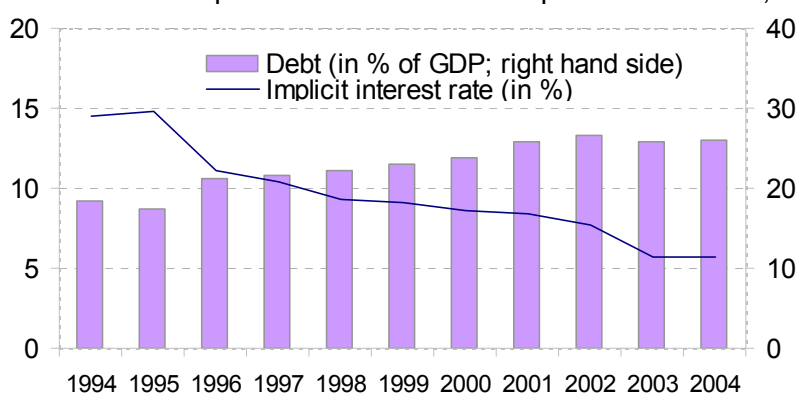
Among these, social financial assistance has gained importance in the last years. It is received by 4.7% of the population, and to some extent provides some revenue amongst others also for those no longer entitled to unemployment benefit. From January 2002 to December 2004 the number of recipients doubled, as did the costs. About 40% of the recipients of financial assistance have finished primary school or less and almost 95% of the recipients have finished secondary school or less. Most recipients are less than 60 years old. This payment is adjusted once a year for the CPI inflation of the previous year. Entitled persons are adult persons and children in households that do not reach the minimum income as defined by the law on social protection.

The main change in the area of family-related expenditure was introduced in 1999. Under this category, the largest expenditure items are parental compensation and child allowances. The first represents wage compensation during parental leave, which is set at one year in Slovenia. Parental compensation depends in general on individual's earning in the last 12 months. Expenditure on child allowances has increased as a consequence of the reform, as allowances were extended and amounts involved increased, again in a gradual manner.

#### 2.5. Interest payments

Interest payments have been driven by debt developments and by the decline in nominal interest rates in line with the disinflation process. Interest payments amounted to 0.5% of GDP in 1992 and increased to 1.2% of GDP in 1993. Thereafter, they have remained relatively stable at approximately this level. They further increased to 1.4% of GDP in 2000 and 1.6% of GDP in 2002 and 2003. In 2004 interest payments declined due to larger reductions in the implicit interest rate.

Chart 11: Debt of the Republic of Slovenia and implicit interest rate, 1994-2004



Source: Ministry of Finance of the Republic of Slovenia, author's estimates.

#### 2.6. Investment expenditure

Investment expenditure fluctuated at around 4% of GDP throughout most of the period. The only exception were the first two years, when immediately after independence other priorities

were set. Such constant share of investment expenditure is somewhat surprising, as this is seen as the expenditure category that can be most easily adjusted.

In the very near future some changes will be needed in this item in the relation to the European budget. Co-financing requirements will require some restructuring and clearer priority setting.

### 3. POLICY ISSUES: ADJUSTMENT PROCESS

Analysis shows that the main policy issues in the future will be:

- rethinking spending priorities, among other things by better targeting transfers to specific groups,
- increasing efficiency, which is difficult to measure (changes in the management of public sector),
- outsourcing to the private sector.

Given the limited scope for revenue increases<sup>23</sup>, there is a need to cut expenditure. Analysis shows that the reduction in transfers to households, together with a reduction in public sector wages and employment will be necessary in Slovenia to put public finances in a better position (taking into account also the high tax burden, not analysed here).

For an adjustment process to be successful, measures taken to reduce expenditure should be of a permanent nature. Alessina and Perotti (1995) show that adjustments based on social transfers and public sector wages are more persistent than those based on investments. Adjustment in investment spending is also (politically) the easiest to follow.

There is also a need for better-focused expenditure targeting, meaning targeting transfers to the groups/sectors that need them most.

Experience also shows that such measures are more effective in times of good economic growth. For Slovenia, the macro-economic forecast shows that growth is expected to be around 4% of GDP in the coming years, therefore making it possible for the measures to be introduced.

### 4. CONCLUSIONS

In Slovenia, general government expenditure has increased in the period after independence as a percentage of GDP, and is currently at a level comparable to the European Union average. Meanwhile, revenue also increased, but less so. This has resulted in increased deficits in the general government sector.

The fastest growing general government expenditure groups have been wages and transfer payments. The former has grown both because of increases in individual real wages as well as due to growth in public sector employment. The decline in economic activity at the beginning of the 90s, which resulted in large early retirement and unemployment

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<sup>23</sup> Revenues were 46.2% of GDP in 2003 in Slovenia, compared to 45.8 % of GDP for the EU-15 average as measured by the ESA95 methodology. This indicates a large burden on the economy. For this reason and in an effort to reach the Maastricht price stability criterium, further increases in the revenue ratio would not be welcomed. Indeed, Slovenia introduced personal income tax reform in 2005, which will result in lower revenues, while reform in corporate income tax will compensate for most of the loss.



expenditure, was behind the upward trend in transfer payments in this period. High growth in health spending and the introduction of some more favourable transfer payments, for example, in the area of child and family benefits, contributed to the overall trend in expenditure.

Two main achievements in the area of expenditure policy are worth mentioning. The first is the pension reform introduced in 2000, which according to our rough calculations has already resulted in 0.8% of GDP savings on old-age pensions. The reform has substantially decreased the unfunded liabilities of the PAYG system; however, more pronounced pressures are expected to show up again around 2015 to 2020. The second one is better control over increases in individual general government wages, which show recent modest growth.

Currently, the general government deficit fluctuates at around 2% of GDP, as measured by the ESA95 methodology, which is relatively close to the 3% Maastricht reference value. The goal of fiscal policy is to reduce the deficit and to reach a position close to (structural) balance. In order to reach this goal an adjustment of expenditure will be needed. Such a development would also give a larger safety margin for the case of unexpected macroeconomic developments and substantially improve long-term sustainability of public finances.

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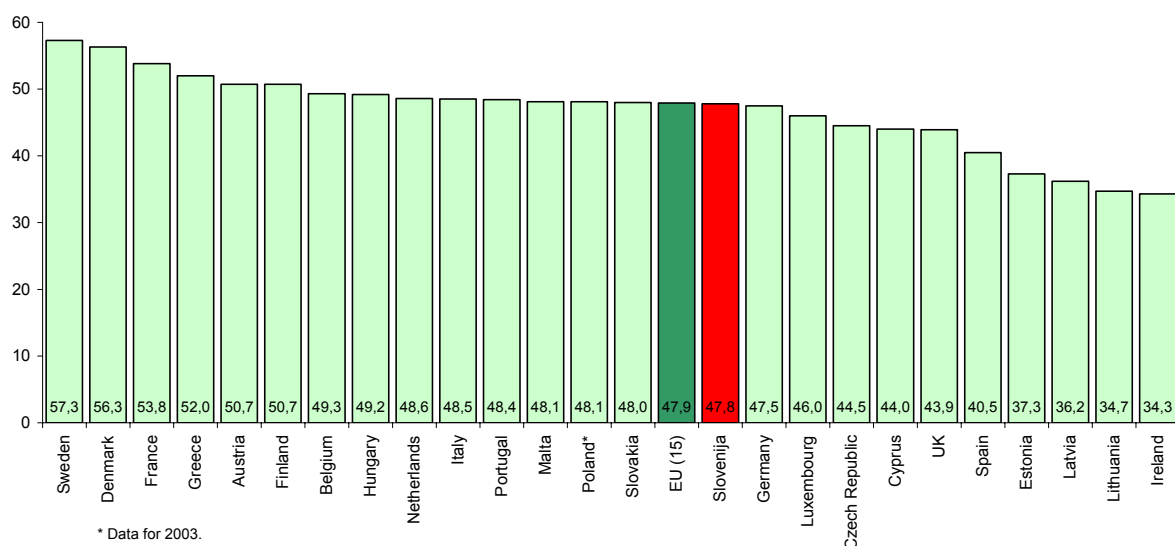
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**ANNEX I****Chart 1: General government expenditure in the EU-25 as a share of GDP, 2004.**

Source: Eurostat.

**Table 1: General government expenditure in Slovenia by type, 2000-2004.**

	2000	2001	2002	2003	2004	change
<b>Total expenditure</b>	<b>48,2</b>	<b>47,9</b>	<b>48,1</b>	<b>48,2</b>	<b>47,8</b>	<b>-0,4</b>
Intermediate consumption	7,2	7,2	7,4	7,1	6,8	-0,4
Compensation of employees	11,8	12,3	12,1	12,3	12,1	0,3
Other taxes on production	0,5	0,5	0,5	0,5	0,6	0,1
Subsidies	1,5	1,4	1,2	1,5	1,6	0,1
Property income, payable	2,4	2,4	2,3	2,1	1,9	-0,5
Social benefits in cash and in kind	19,2	19,2	19,3	19,3	19,0	-0,2
Other current transfers, payable	1,2	1,1	1,3	1,3	1,9	0,7
Capital transfers, payable	1,4	1,3	1,1	1,1	1,1	-0,3
Capital formation	3,1	3,0	2,8	3,0	2,8	-0,3
Acquisition less disp. of non-fin. non-prod.assets	0,0	-0,6	0,0	0,0	0,0	0,0

Source: Statistical Office of the Republic of Slovenia, First Release, 66/2005

**Table 2: General government expenditure by type in 2003 in % of GDP**

	Slovenia	EU-15*	Belgium	Czech R.	Denmark	Germany	Estonia	Greece	Spain*	France	Ireland*	Italy	Cyprus
<b>Total expenditure</b>	<b>48,2</b>	<b>47,5</b>	<b>51,0</b>	<b>53,2</b>	<b>56,4</b>	<b>48,1</b>	<b>35,8</b>	<b>48,1</b>	<b>38,3</b>	<b>53,6</b>	<b>33,7</b>	<b>49,0</b>	<b>45,4</b>
Intermediate consumption	7,1	6,2	3,4	7,4	8,7	4,1	7,6	5,6	4,2	5,4	5,8	5,3	5,9
Compensation of employees	12,3	10,8	12,1	8,3	17,9	7,8	10,2	11,8	9,9	13,6	8,4	11,0	15,7
Other taxes on production	0,5	0,2	0,0	0,1	0,0	0,0	0,0	0,0	0,0	0,4	0,0	0,7	0,0
Subsidies	1,5	1,2	1,6	2,7	2,2	1,3	0,9	0,1	1,2	1,3	0,9	1,1	1,2
Property income, payable	2,1	3,3	5,4	1,3	3,4	2,9	0,3	5,8	2,7	2,9	1,4	5,4	3,4
Social benefits in cash and in kind	19,3	20,4	23,3	18,2	18,5	27,1	11,6	17,2	14,3	24,0	9,9	19,8	11,5
Other current transfers, payable	1,3	1,9	2,2	1,1	3,7	1,8	0,9	1,5	1,2	1,9	2,2	1,5	3,6
Capital transfers, payable	1,1	1,2	1,3	9,9	0,4	1,6	1,0	2,0	1,4	0,7	0,9	1,4	0,7
Capital formation	3,0	2,3	1,6	4,0	1,7	1,5	3,4	3,9	3,4	3,2	4,5	2,6	3,4
Acq. less disp. of non-fin. non-prod.assets	0,0	0,0	0,0	0,1	0,0	-0,1	...	0,1	0,0	0,1	-0,2	0,0	0,0

**Table 3: General government expenditure by type in 2003 in % of GDP (continued)**

	Latvia	Lithuania	Luxembourg	Hungary	Malta	Netherlands	Austria	Poland	Portugal	Slovakia	Finland	Sweden	UK
<b>Total expenditure</b>	<b>35,7</b>	<b>34,1</b>	<b>45,5</b>	<b>50,2</b>	<b>50,9</b>	<b>49,0</b>	<b>50,8</b>	<b>44,5</b>	<b>47,6</b>	<b>39,2</b>	<b>50,9</b>	<b>58,7</b>	<b>43,5</b>
Intermediate consumption	8,7	6,1	3,9	6,6	4,5	7,0	4,5	6,6	3,8	6,1	8,9	10,2	11,5
Compensation of employees	11,1	11,0	8,8	13,3	15,5	10,8	9,6	11,8	14,9	9,0	13,8	16,6	10,4
Other taxes on production	0,0	...	0,0	0,0	0,0	0,1	0,2	0,1	0,0	0,3	0,1	1,0	0,1
Subsidies	0,8	0,8	1,7	1,5	2,2	1,4	3,2	0,5	1,5	1,7	1,3	1,5	0,7
Property income, payable	0,8	1,3	0,2	4,2	3,9	2,9	3,1	3,0	2,9	2,5	2,0	2,4	2,0
Social benefits in cash and in kind	10,2	10,7	21,3	17,1	13,7	20,9	24,2	18,6	17,2	14,8	19,0	21,5	13,6
Other current transfers, payable	0,8	0,1	2,9	1,9	2,3	1,7	2,8	0,4	2,8	1,3	2,6	2,2	2,7
Capital transfers, payable	1,6	1,2	1,9	2,4	3,5	0,6	2,1	0,3	1,3	0,7	0,2	0,3	1,0
Capital formation	1,8	3,0	4,8	3,4	5,4	3,6	1,2	3,3	3,3	2,5	3,0	3,1	1,7
Acq. less disp. of non-fin. non-prod.assets	0,0	0,0	0,0	0,2	0,0	0,0	-0,1	...	-0,1	-0,1	-0,1	-0,2	-0,1

Source: Eurostat  
\* Data for 2002.

**Table 4: General government expenditure by function in 2002 in % of GDP**

	Slovenia	EU-15	Belgium	Denmark	Germany	Greece	Spain	France	Ireland	Italy	Luxem.	Netherl.	Austria	Portugal	Finland	Sweden	UK	Latvia*
General public services	8,8	6,8	9,9	8,5	6,2	10,7	5,6	7,2	3,5	9,1	5,0	8,2	7,7	6,4	6,1	8,8	4,2	5,3
Defence	1,4	1,7	1,2	1,6	1,2	2,7	1,2	2,4	0,7	1,2	0,3	1,5	0,9	1,7	1,4	2,1	2,5	1,3
Public order and safety	2,0	1,7	1,6	1,0	1,6	1,1	2,2	1,0	1,5	1,9	1,1	1,7	1,4	2,0	1,4	1,5	2,1	2,4
Economic affairs	3,4	4,0	4,6	3,7	4,0	4,5	4,4	4,8	5,0	3,9	5,2	5,4	5,2	5,2	5,0	4,8	2,4	3,7
Environment protection	0,4	0,7	0,7	...	0,6	0,6	0,9	1,2	...	0,8	1,2	0,8	0,3	0,6	0,3	0,3	0,6	0,4
Housing, community amenities	0,2	0,8	0,3	0,9	1,1	0,5	1,1	1,0	2,1	0,1	0,8	1,5	0,8	0,9	0,5	0,9	0,5	0,9
Health	6,8	6,5	6,7	5,6	6,4	3,1	5,4	8,4	6,4	6,5	4,9	4,5	6,7	6,9	6,3	7,1	6,4	3,3
Recreation, cultur, religion	1,0	0,8	1,2	1,7	0,7	0,4	1,1	0,8	0,5	0,9	1,9	1,1	1,1	1,2	1,2	1,1	0,5	1,4
Education	5,7	5,1	6,4	8,3	4,2	3,2	4,4	6,0	4,3	4,9	5,1	4,9	5,7	7,0	6,6	7,5	5,0	6,2
Social protection	18,3	19,0	17,8	24,5	22,4	20,0	13,6	20,6	9,3	18,2	18,6	17,9	21,6	14,0	21,3	24,1	15,7	10,8

Source: Eurostat, Statistics in focus, 43/2004, Statistical Office of the Republic of Slovenia, First Release, 87/2005. EC: Public finances in EMU, 2005. \* 2003

## ANNEX II

### DEMOGRAPHIC PROJECTIONS

We discuss here demographic factors: the fertility rate, life expectancy and immigration flows. For past developments, data from the National Statistical Office were used. Projections for the period up to 2050 are taken from United Nations projections: World Population Prospects: The 2004 Revision, Population database<sup>24</sup>. A medium scenario has been used.

Up to the beginning of the 80-ies the fertility rate in Slovenia was above the replacement rate. It began to decline some 20 years ago. The total fertility rate<sup>25</sup> was 1.2 in 2000, which is historically very low, and also compared to most European Union members. It is assumed that it will gradually reach 1.7 in the projection period, which is less than 2.1, the level necessary for the replacement of generations. This assumption is not important for the projection in the number of elderly people, but has an important impact on the number of young and working-age people, e.g. the number of contributors to the system.

Life expectancy at birth is projected to rise sharply, by some five to six years until 2050, when men are expected to reach the age of almost 79 years and women over 85 years. The median age, which stood at 38.2 years in 2000 (up from 27.7 in 1950), is expected to increase to 51.9 years in 2050.

Annual net immigration flows are expected to remain close to those observed in the last ten years in the next few decades. Thereafter, they are projected to increase, but not substantially and therefore their expected influence on the Pension Fund balance should not be large. High immigration rates seem unrealistic.

<sup>24</sup> <http://esa.un.org/unpp/>

<sup>25</sup> Fertility rate is defined as number of children born to an average woman during her lifetime

Taking all assumptions together, the population in Slovenia is expected to be 1.6 million in 2050, down from the present figure of 2 million, which would mean a 17% decrease in the population (see table)<sup>26</sup>. According to these projections, the population structure will greatly change in the next decades.

Table 1: Population data, Slovenia, 1995-2050.

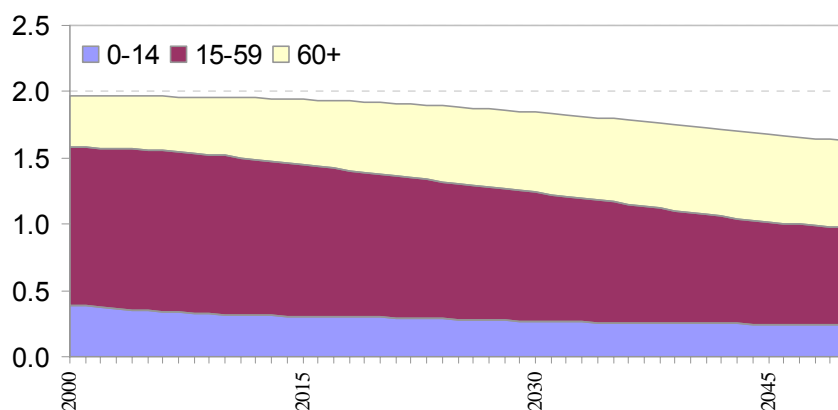
	1995	2000	2005	2010	2020	2030	2040	2050
Population	1.964	1.967	1.964	1.958	1.918	1.842	1.741	1.629
Elderly dependency ratio *	28,0	32,1	33,0	36,8	49,8	62,2	77,9	89,9
Very elderly ratio **	23,3	26,6	31,4	33,1	30,2	36,3	40,4	43,1
Total dependency ratio	56,4	64,8	61,5	63,5	77,1	89,7	107,6	123,7
Life expectancy, men	69,7	71,2	72,6	73,5	75,3	76,7	77,8	78,9
Life expectancy, women	77,4	78,7	79,9	80,7	82,2	83,4	84,4	85,4
Immigration rate	...	0,1	0,1	0,1	0,1	0,1	0,1	0,2
Total fertility rate	1,36	1,25	1,22	1,21	1,32	1,46	1,60	1,74

Source: United Nations World Population Prospects, The 2004 Revision.

\* People aged 60+ to the population 18-59. \*\* People aged 75+ in the group 60+.

The most drastic decline will be in the working population, while the number of persons 60+ will increase. The elderly dependency rate is projected to more than double over the next half century to almost 90% by 2050. This means that the number of elderly will increase sharply. Slovenia is expected to be among those countries where the increase will be most pronounced. Moreover, over 40% of these senior citizens are envisaged to be 75 years of age or older. The total dependency ratio will increase less. It is expected to reach over 100% in 2050. In the short term the most important observation is that elderly dependency ratios will begin to increase sharply as early as between 2010 and 2020, when more retirements are expected.

Chart 1: Population structure, in millions, 2000-2050.



<sup>26</sup> Eurostat's projections, published later, show a different picture: according to them, the population of Slovenia is expected to decline only little by 2050. This indicates how difficult it is to project future population.