



“Better Policies” Series

# SLOVENIA

## THE GROWTH EFFECTS OF STRUCTURAL REFORM

MAY 2015



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# Slovenia: The growth effects of structural reform

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## Key findings

To improve Slovenia's long-term growth prospects and support job creation, comprehensive structural reforms are needed to boost competitiveness, in particular by addressing the country's productivity gap with other OECD countries. Slovenia has implemented many reforms in recent years, including of the pension system and labour and product markets. Other reforms such as the restructuring and recapitalisation of banks, the initiation of privatisations, and changes to the fiscal framework have been legislated and are ongoing, and their full implementation will support growth further going forward.

Drawing on the 2015 OECD Economic Survey of Slovenia, this paper provides a snapshot at the pension, product markets, and labour market reforms that have been implemented or approved and assesses their impact on productivity, employment and GDP. After five years, GDP will be 1% higher than would otherwise be the case in the absence of the reforms. This means that GDP will grow 0.2% faster per year on average over this period thanks to the reforms. In the following five years a further gain of similar magnitude can be expected. These estimates assume swift and full implementation of the reforms - delays, or less than full implementation, would reduce the gains.

- The *product market reforms* are estimated to boost GDP by around 0.7% after five years and 1.3% after ten years. This is driven by higher productivity growth as lighter regulation due to simpler rules on opening a business, reduced administrative burdens, and lower state-control encourage competition. This in turn speeds up the pace of convergence in productivity levels to the most technologically advanced economies. Lighter regulation also encourages firms to produce new ideas and technologies and facilitates the shift of resources from slow- to fast-growing sectors.
- The 2013 *labour market reform* is expected to boost GDP by 0.2% after five years and 0.3% after ten years. The positive GDP effect comes through higher productivity growth via increased flexibility of the labour market. Next to enhanced flexibility, the labour market reform also reduced duality between permanent and fixed-term contracts. This is a positive step, since labour market duality reduces firms' ability to adapt to shocks and unfairly distributes the burden of workforce adjustments towards vulnerable groups.
- The 2013 *pension reform* is expected to boost GDP by 0.1% after five years and 0.4% after ten years. The positive GDP effect comes through higher employment via increased incentives for older people to stay in the labour market. By increasing the statutory and minimum retirement ages and reducing the implicit tax on continued work for older people, the reform also made the pension system more sustainable.

## Quantifying the effects of the reforms: details and analyses

The Slovenian government has implemented a number of important structural reforms in recent years to boost growth. This paper provides an estimate of the impact of the product and labour market reforms as well as of the pension reform on productivity, employment and GDP. The assessment suggests that the reforms could increase the level of GDP by 1% within the first five years following the reform and by 2% within the first ten years (Table 1). At the 10-year horizon, about 20% of the effect is due to higher employment, while the remaining part is due to higher productivity. Details on the reforms that are taken into account in the analysis are found in the Annex.

**Table 1. The impact of recent structural reforms on GDP over 5 and 10 years**

	in percent		
	GDP	Via Employment growth	Via Productivity growth
<b>Impact after 5 years</b>			
Product Market Reform	0.7		0.7
Labour Market Reform	0.2		0.2
Pension reform	0.1	0.1	
<i>Total</i>	<i>1.0</i>	<i>0.1</i>	<i>0.9</i>
<b>Impact after 10 years</b>			
Product Market Reform	1.3		1.3
Labour Market Reform	0.3		0.3
Pension reform	0.4	0.4	
<i>Total</i>	<i>2.0</i>	<i>0.4</i>	<i>1.6</i>

1. OECD estimates for the impact of product market reform include changes to the product market regulation (PMR) as captured by the change in the OECD PMR indicator between 2008-2013, announced privatisations and reforms via EU commitments. The 2008-2013 change in the PMR is assumed to start having an effect on growth two years before other reforms.
2. Impact on the labour market reform is assessed via the effect of the change in the employment protection legislation (EPL) on growth.
3. Effect of the pension reform is based on a judgement and assesses the effect on employment via increased incentives for older people to stay in the labour market.

*Source: OECD calculations.*

The quantitative assessment accounts for two types of reforms (1) past reforms which have already been implemented and (2) additional measures which have been announced and approved by the parliament.

The quantitative assessment adopts the same methodology to estimate the effects of structural reforms as the OECD uses for the assessment of G20 countries' reform commitments in the Brisbane Action Plan. First, each reform measure is evaluated in terms of quantifiable variables, including standard OECD indicators where necessary. These indicators are typically the Product Market Regulation (PMR) indicators and the Employment Protection Legislation (EPL) indicators. Then a series of equations relate each reform measure to their expected effects on productivity and/or employment. The simulation results for Slovenia are obtained assuming that the structure of the economy corresponds to the average of France, Italy and Spain.

The quantitative assessment primarily focuses on reform measures for which the estimated effects are relatively well-established and straightforward to be understood. It relies on existing OECD empirical studies of the links between structural policies and productivity or employment, and covers the following areas: *i*) product market reform, *ii*) labour market reform (reform of employment protection legislation) and *iii*) pension reform.

## Product market reform

By spurring competition product market reform can accelerate the convergence in productivity levels to the most technologically advanced economies. Stronger competition encourages firms to become more efficient and to invest in innovation and knowledge-based capital. It also increases growth and employment by encouraging the creation of new companies – through lower barriers to entrepreneurship – and the expansion of existing ones that can take advantage of new markets, products or processes. Product market reforms can also boost aggregate productivity by enhancing the country's capacity to re-allocate capital and labour from declining or slow-growing to fast-growing sectors.

Slovenia's overall regulatory framework is among the most restrictive in the OECD, which stems largely from the pervasive state involvement in the economy. But there is also room to reduce the complexity of regulatory procedures and administrative burdens imposed on new companies. To tackle these issues, a number of reforms to the business environment have been implemented. Specifically, between 2008 and 2013, the government introduced simpler rules on starting a business, reduced administrative burdens on new companies and sole proprietors and established single contact points for getting information on all notifications and licenses. Additionally, the parliament approved a list of 15 companies to be privatised and the government committed to privatising state-owned banks. By early 2015 five companies were privatised and the remaining ones are in the process of being privatised. Slovenia also has to implement reforms as part of the completion of the European Telecom Single Market, the Third EU Energy Package and the EU's commitment to open the railway market for competition.

Together, the already implemented product market reforms and those to which Slovenia is committed should boost productivity and GDP by around 0.7% within the first five years after the reforms and by another 0.6% within the following five years.

The Slovenian government has also implemented a number of growth-enhancing product market reforms that cannot be quantified within the OECD's framework. Examples are the 2013 improvements in insolvency procedures, which should facilitate the restructuring of companies, and the establishment of the Slovenian Sovereign Holding (SSH) in April 2014, which should improve the management of the state-owned assets and improve corporate governance.

## Labour market reform

Reforms that reduce the stringency of employment protection legislation (EPL) and reduce the costs of hiring and firing can support growth by facilitating the allocation of labour resources. They make it easier for firms to respond quickly to changes in demand or technological advancements that require the reallocation or downsizing of staff. A study by Bassanini et al. (2009) supports this view, showing that stringent EPL weakens productivity in sectors where labour turnover is "naturally" high.

Before the 2013 labour reform, Slovenia was among the OECD countries with the strongest protection of workers on permanent contracts and no direct costs for terminating fixed-term contracts. The aim of the reform was to increase labour market flexibility and decrease labour market duality. The reform introduced greater flexibility by simplifying administrative procedures related to hiring and firing and shortening notice periods and lowered the costs of permanent employment contracts by reducing severance payments. For fixed-term contracts, it introduced redundancy payments and limited to two years the maximum duration of a fixed-term employment for a given job. In the case of termination, employers' costs are now the same for both contract types.

According to a survey by the Bank of Slovenia (2014) only 14% of companies reported a change in their human resources policy due to the new legislation. Still, evidence points, however, to a slight reduction in labour market duality as the share of permanent contracts among new hires increased from 24% to 28% within a year (IMAD, 2014). The OECD framework estimates the productivity and GDP effects of reduced protection of individuals with permanent contracts at 0.2% in the first five years after the reform. In the following five years a somewhat smaller effect is expected, so that the total GDP and productivity effects after ten years amount to around 0.3%.

The OECD framework does not allow quantifying the reform of student work that came into force in February 2015. Student work had been a major factor behind labour market duality, as it benefited from a preferential tax and regulatory treatment. The very welcome reform introduced a minimum hourly gross wage rate for student work, together with healthcare and pension contributions. Students will now accumulate years of pensionable service from their work. These changes make student work more comparable to regular employment contracts regarding costs, while maintaining its greater flexibility.

### **Pension reform**

A pension reform that increases older people's incentives to stay in the labour market, for instance by reducing the implicit tax on continued work or raising the statutory retirement ages, should have a positive effect on employment and, via better labour utilisation, on GDP.

The pension reform that Slovenia launched in 2013 strengthened the link between contributions paid and pensions received and equalised the statutory retirement age for men and women – for both genders the statutory retirement age will be gradually raised to 65 years by 2020. The reform increased penalties for early retirement (the pension is reduced by 0.3% per month of retirement before the statutory retirement age) and introduced a bonus for continued work (the pension is increased by 1% for every three-month period of work beyond the statutory retirement age with a maximum bonus of 12%). The new measures have helped slowing down the inflow of new applicants into the pension system (MDDSZ, 2014), though this has to be seen in the context of a strong inflow into the pension system just before the reform became effective.

OECD estimates suggest that the pension reform will boost GDP by 0.1% in the first five years after the reform and by another 0.3% within the following five years. This GDP effect comes through a rise in employment, which will increase by 0.2% within the first 5 years of the reform and another 0.2% within the following 5 years. The contribution of employment to GDP growth is disproportionately larger at the 10-year horizon despite the similar pace of employment growth because the 10-year effect assumes that the capital stock increases by as much as employment to recover the pre-reform level of the return to capital.

### **Changes in the fiscal and banking framework**

The Slovenian government has also introduced a number of changes to the fiscal and banking framework, which could not be quantified within the OECD's framework. Nonetheless, these changes can be expected to contribute positively to economic growth and stability in Slovenia. The reforms to the fiscal framework are expected to limit public expenditure growth in the future via a fiscal rule that requires a balanced budget over the medium term and to improve the collection of revenues via measures countering tax evasion. This is expected to lower public debt and free resources for more growth-friendly spending.

The measures in the banking sector should have helped to restore confidence and bring interest rates on public debt down to more sustainable levels. The weakened banking system was recapitalised and some non-performing assets were transferred to the newly established Bank Asset Management Company (BAMC). BAMC has the power to seek a quick resolution of impaired assets. Additionally, bank supervision is being strengthened. The National Assembly passed a law establishing a bank resolution fund, which will become operational in 2015 and will be financed by banks and managed by the central bank. In addition, a macro-prudential institutional framework has been established by the Bank of Slovenia.

## Annex: Reforms taken into account in the quantification exercise

Reform area	Reform content
<b>Product market reform</b>	
Various product market reforms during 2008-13	Reforms include improvements in the governance of state-owned assets, reductions in the government's involvement in network sectors, a shortening of the number of days required to open up a business, the introduction of single contact points for getting information on all notifications and licenses to open up a business, and the simplification of regulatory procedures and administrative burdens on start-ups and sole proprietors.
Privatisation	The parliament approved a list of 15 companies to be privatised. By early 2015 five companies had been privatised and the remaining ones are in the process of being privatised. The government has also committed to privatise state-owned banks.
EU commitment on Single Telecom Market	A legislative package for the completion of the European Telecom Single Market was voted by the European Parliament in April 2014 and has to be approved by the EU Council. The proposed package would strengthen network neutrality rules across borders and cut international roaming charges in the EU. Following an agreement reached with the EP in February 2014, the Council adopted the Directive on broadband cost reduction on 8 May. EU Member States must now adopt national provisions to comply with the new Directive by 1 January 2016 and they must apply the new measures from 1 July 2016.
EU commitment in the energy sector	In the energy sector the priority for the coming years should be the completion of the energy internal market through the transposition and implementation of the Third Energy Package, which should be achieved by the end of 2014. Its major elements concern the unbundling of networks, the strengthening of the independence and power of national regulators, and the improvement of the functioning of retail markets.
EU commitment in transport	In transport, the main priority is the opening of the railway market for competition through, among other things, the separation between infrastructure and services and open procedures for public service obligations. These issues are addressed by the Fourth Railway package proposed by the European Commission. In June 2014, the Council reached political agreement on the draft directives on the interoperability and safety of European railways and the draft regulation on the European Railway Agency. Together, these three legislative acts make up the technical pillar of the Fourth Railway package.
<b>Labour market reform</b>	
Employment Protection Legislation	Several measures to increase labour market flexibility and reduce segmentation were implemented in April 2013: reduced notice periods and severance payments for permanent employees, introduction of severance payments for temporary contracts, simplification of administrative procedures related to hiring and firing, introduction of quotas to agency workers.



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## Pension reform

Retirement age	The retirement age is being equalised for men and women and will be gradually raised to 65 years by 2020. Under the previous system, men could retire at 63 and women at 61. Also, the age at which a person may retire at a full pension if he/she has 40 years of actual employment (or periods for which contributions were paid with regard to maternity, sick leave or unemployment) was raised from 58 to 60.
Early and deferred retirement	The reform increased penalties for early retirement and increased rewards for continued work. In case of early retirement, the pension is reduced by 0.3% per month of retirement before the statutory retirement age. Conversely, a bonus is provided for deferred retirement, with the pension being increased by 1% for every three-month period of work beyond the statutory retirement age. The maximum pension bonus a person can obtain is limited to 12%.
Pension base	The calculation of the pension base takes into account the 24 consecutive years of insurance that are most favourable for the individual, as opposed to the 18 years under previous system.

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