

An aerial photograph of a coastal town, likely in Slovenia, showing a dense cluster of buildings with red-tiled roofs. The town is situated on a hillside overlooking a large body of water, possibly the Adriatic Sea. The sky is clear and blue. A teal banner is overlaid on the top right of the image, containing the title and authors of the report.

Slovenia Diagnostics: Assessing Progress and Challenges in Developing a Sustainable Market Economy

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European Bank
for Reconstruction and Development

Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank's mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (**BEEPS**) and the Life in Transition Survey (**LITS**), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD's Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

For more information, go to: www.ebrd.com/publications/country-diagnostics



European Bank
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Slovenia Diagnostic

2018

Abbreviations

ATQ	Assessment of transition qualities
B2B	Business-to-business
BAMC	Bank asset management company
BEEPS	Business Environment and Enterprise Performance Survey
CEE	Central and Eastern Europe
CESEE	Central, Eastern and Southeastern Europe
CoO	Country of operation
DTF	Distance to frontier
EBITDA	Earnings before interest, tax, depreciation and amortization
EA	Euro area
EC	European Commission
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
IMF	International Monetary Fund
LiTS	Life in Transition Survey
Mtoe	Million tonnes of oil equivalent
NPL	Non-performing loan
PM	Particulate matter
ROA	Return on assets
SLO	Slovenia
SMEs	Small and medium-sized enterprises
SOE	State-owned enterprise
USA	United States of America
WB	World Bank
WEF	World Economic Forum

Executive summary

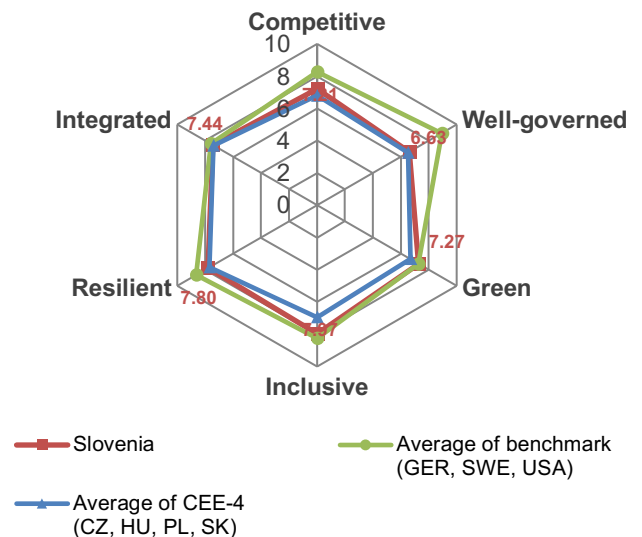
The private sector in Slovenia is smaller than in EA or peer CEE countries¹ but is potentially vibrant. Evidence for this comes from the relatively high number of “hidden champions” – small but highly successful companies on a global scale. But tax rates and regulations, the administrative burden and restrictive labour regulations are all important constraints on private sector development. Other problems include: a) large-scale corporate deleveraging over the past decade (due to the global financial crisis and the 2012-2013 banking crisis), resulting in potential underinvestment; b) the still prominent role of the state in the economy; and c) underdevelopment of capital markets and heavy reliance on bank financing.

Since 2008, investments have stumbled and productivity convergence has stalled. Given the shrinking labour force, the pace of productivity growth of the Slovenian economy will determine its medium- and long-term economic outlook. A firm-level analysis in this paper suggests that, out of the EBRD’s six transition qualities, closing the transition gaps in the competitive and well-governed qualities would boost productivity and growth the most, in line with the EBRD’s assessment showing that the largest transition gaps lie in these two qualities (Chart 1).

The strong reliance on bank finances and still potentially present corporate over-indebtedness highlight the need for more equity financing and better corporate governance. Both SOEs and private companies could benefit from improved corporate governance. It could be done through improving the structure and functioning of boards, internal control and shareholder rights, and simplifying the extremely complex ownership structures in SOEs.

This paper assesses the main challenges in unlocking private sector potential and developing a sustainable market economy in Slovenia. The paper consists of a brief overview of the private sector in Slovenian economy and constraints affecting its further development. It also provides a brief political and economic outlook as well as a quality-by-quality description of the main transition gaps, according to the EBRD methodology for measuring transition.

Chart 1: ATQ scores for Slovenia



Note: The level of development within each of the six qualities is measured from 1 to 10, with 1 meaning little or no progress and 10 representing the global frontier.

¹ Czech Republic, Hungary, Poland and Slovakia (the Visegrad group). Throughout the diagnostics they are also termed CEE-4.

1. A small but potentially dynamic private sector

The share of private sector in Slovenia is lower than in EA or peer CEE countries. At 71.2 per cent in 2014, the private sector employment share is below that of the EA (79.4 per cent) or the CEE² average (74.3 per cent).³ The true share may be even lower due to the complex ownership structures of many Slovenian SOEs (see Figure 1).⁴ As in other EU countries, the vast majority of Slovenian companies (95 per cent) are micro enterprises (with fewer than 10 employees), whose share in total employment or value added is disproportionately lower (36 and 23 per cent, respectively) than their share in the number of companies. SMEs, excluding micro enterprises, account for 38 per cent of total employment, which is similar to the EU average. However, in comparison to the EU, Slovenian SMEs account for a somewhat smaller share in the total number of enterprises (5 vs. 7 per cent) and slightly more in value added (41 vs. 36 per cent). Overall, it seems that these enterprises have been recovering relatively well from the recent crises, as employment level in 2016 was just 1.2 per cent below the 2008 value.⁵

The private sector has potential for further growth through privatisation. Despite four waves of privatisation since the country's start of transition in 1991, the process is far from finished. At end-2016, assets in the Republic of Slovenia portfolio were worth €42.6 billion,⁶ or 104 per cent of GDP. Key sectors (and companies) in state hands are: banking (NLB⁷, Abanka), insurance (Sava, Triglav), energy (electricity company Holding Slovenske elektrarne and oil company Petrol), transport (Port of Koper), telecommunications (Telekom Slovenije), postal services (Pošta Slovenije), manufacturing (toolmaker Unior), and gaming (casinos Bled and Portorož).

Private sector growth could be also enhanced by business environment reforms, on top of those introduced over the past decade. The country moved from 55th place in 2008 to 40th (out of 190 countries) in 2018 in the World Bank's Ease of Doing Business report. While Slovenia is doing very well in several areas, including trading across borders (1st), resolving insolvency (9th) and getting electricity (23rd), in other areas, like enforcing contracts (110th), getting credit (112th) or dealing with construction permits (120th), it is lagging behind. It could also improve further the rank in starting a business (38th), but it is worth noting substantial progress in this area achieved since 2008 when the country ranked 120th. According to the fifth round of the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS V) carried out in 2013, the main business constraints in Slovenia are political instability, tax administration and access to finance. The 2017 World Economic Forum (WEF) report pointed to tax rates and regulations, inefficient government bureaucracy and restrictive labour regulations as some of the main problems.

Access to finance for SMEs could be improved further. According to the EC, in 2017 only 7 per cent of Slovenian SMEs considered access to finance as the most important concern vs. 28 per cent in 2014 and 15 per cent in 2015. Similarly, access to finance was seen as an issue by 7.7 per cent of the polled managers in the 2017 WEF's Executive Opinion Survey (vs. 14 per cent two years before). Still, financing conditions could be improved further by reducing the still high level of NPLs to SMEs (due to which banks still exercise great caution when financing these companies) and by enhancing access to alternative financing, which is particularly important for innovative high-growth SMEs.

² Hungary, Poland and Slovakia.

³ Data are from 2014 or the latest available year (International Labour Organisation) http://www.ilo.org/ilostat/faces/ilostat-home/home?_adf.ctrl-state=rb147c24e_4&_afLoop=274558774490768#

⁴ Complex ownership structures of SOEs might also be a reason why publicly available data on the size of private sector in Slovenia are scarce.

⁵ Data on SMEs refer to 2016 (EC's 2017 SBA Fact Sheet Slovenia).

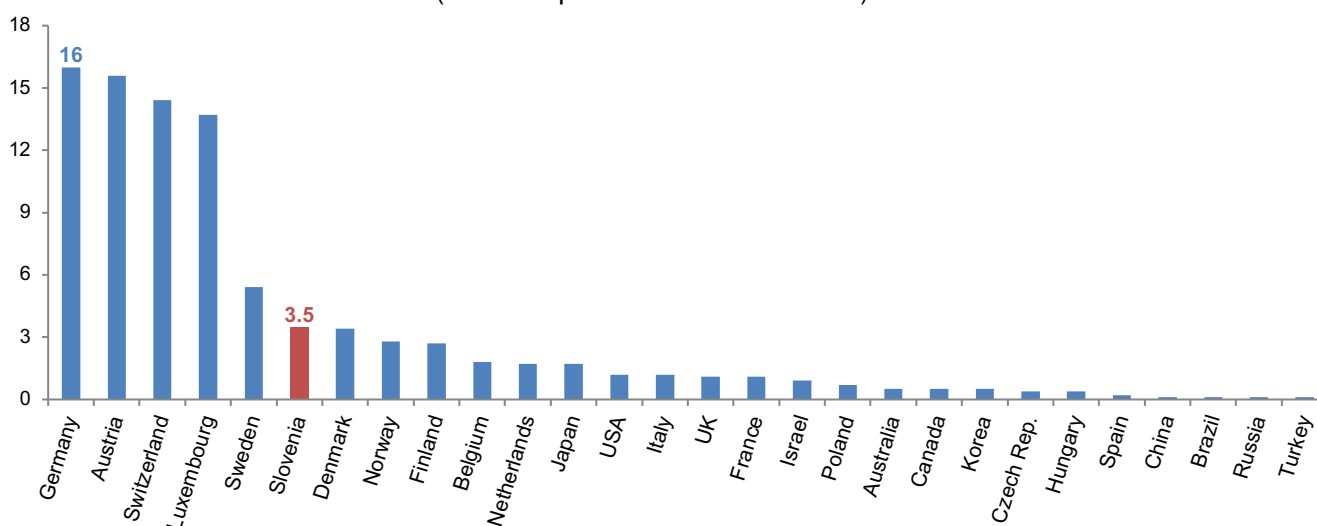
⁶ According to Slovenian Sovereign Holding, <http://www.sdh.si/en-us/asset-management/the-portfolio-by-sectors>.

⁷ In November 2018, 59.1 per cent of NLB was sold, but the Slovenian state remained the main shareholder in the bank (with 40.9 per cent ownership).

The relatively high number of so-called “hidden champions”⁸ indicates a potentially vibrant private sector. “Hidden champions” are highly successful small or medium-sized companies that usually serve niche markets or operate in the B2B segment, which makes them rather invisible to the wider public. With 3.5 “hidden champions” per one million of inhabitants in 2012, Slovenia ranked 6th out of 28 countries assessed and 1st in the CEE region⁹ where the average was only 0.5 (see Chart 2). According to other sources, Slovenia performs even better, with 7.5 “hidden champions” per one million inhabitants.¹⁰ These companies range from little-known manufacturers of electric motor or car parts and relatively simple metal products like office filing mechanisms, to makers of ultra-light aircrafts. Unlike German “hidden champions”, whose median age is over 60 years, the Slovenian ones are mainly young – most of them were founded in the 1990s. The age difference might partly explain the still relatively small revenues of Slovenian champions (the highest being under €200 million in 2015).

The future of Slovenian hidden champions is hard to predict. Although one would expect that such narrow-focused SMEs, usually tightly managed by the owners, are bound to remain small and in the end disappear, they have actually proved quite resilient, even to the global financial crisis. In general, these companies exhibited a higher survival rate than the average in their sector, and grew their market share on the account of bankrupt competition.¹¹ Over time, some have even grown from “hidden” to “big” champions. However, data show that, in the case of Slovenia, the majority of 15 champions identified by Purg and Rant (2011) had lower or at best similar revenues in 2015 as in 2009, while only five have managed to grow at an average annual rate of over 10 per cent, doubling or tripling their revenues in the meantime. In addition, even among the better-performing companies, two of them recorded declining revenues in the last couple of years. Whether this is only a temporary development caused by two severe crises the country went through over the past decade or an indication of “failing champions” is a subject for further research.

Chart 2: “Hidden champions”
(number per million inhabitants)



Source: Simon, H. (2012), available at: <http://km.vse.cz/wp-content/uploads/2012/05/2H01X013-prag-hc-090312.pdf>

⁸ According to German business expert Hermann Simon (see Simon, H. (2009): *Hidden Champions of the 21st Century: Success strategies of unknown world market leaders*, Springer), those enterprises possess three distinctive features. They are: (i) leaders in terms of market share in their respective fields (among top 3 in the world or No. 1 on the continent), (ii) earning modest revenues (no more than €1 billion, with some exceptions), and (iii) “hidden” (i.e. not well known to general public).

⁹ Czech Republic, Hungary and Poland.

¹⁰ See Purg, D. and Rant, M. (eds.) (2011): *Hidden Champions in CEE and Dynamically Changing Environments*, Research Report, Central and East European Management Development Association (CEEMAN).

¹¹ Simon, H. (2009).

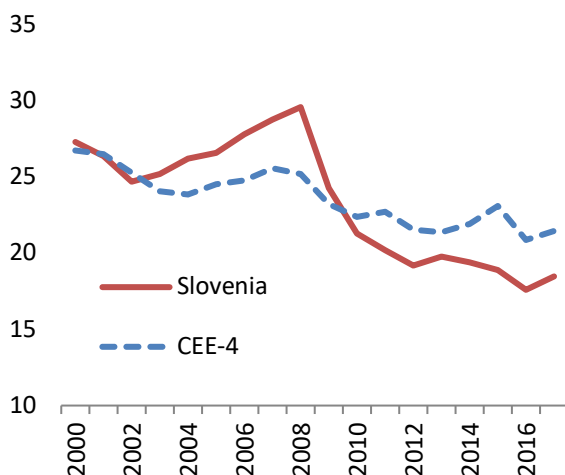
2. Constraints on private sector development

2.1. Significant corporate deleveraging over the past decade, which has contributed to potential underinvestment

Slovenia has gone through a double-dip recession since 2008. Cheap bank credit prior to 2008, financed by foreign funds, led to over-investment and an unsustainable corporate debt build-up (Chart 4). As a consequence of the external demand shock and sudden stop of capital inflows, coupled with the end of the domestic investment cycle, the economy experienced a severe recession in 2009. Although some recovery ensued in the following two years, highly indebted corporates were unable to service their debts, putting the (mostly state-owned) banking system under systemic stress. The crisis ultimately spilled over to the sovereign, leading to a new recession in 2012–2013. The state stepped in by recapitalizing Slovenia’s three largest banks (at a cost of around 11 per cent of GDP) which, together with large NPL transfers to an independent bank asset management company (BAMC), restored confidence in the financial system.

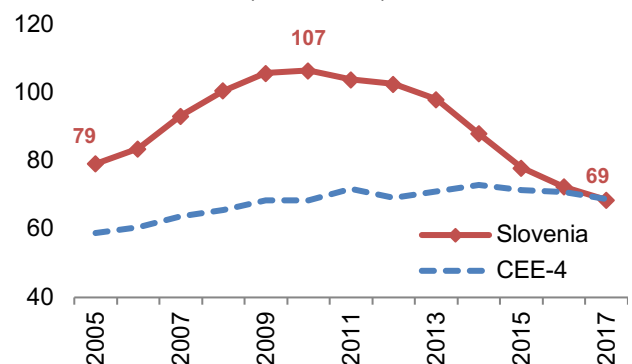
In the last four years, the economy has been recovering. The recovery has been supported by bank recapitalisation, multi-creditor agreements to restructure corporate debt, steps to improve the governance of state-owned enterprises, the first sale of a recapitalized bank (NKBM) and other reforms (fiscal consolidation, pension reform, labour market reform, etc.). Exports have also performed well. Over 2007-2016, the volume of goods exports (mainly vehicles, electrical machinery, general machinery, pharmaceuticals, and fuel) grew at an average annual pace of 2.5 per cent (vs. GDP growth of only 0.1 per cent on average), offsetting the drop in domestic demand and also helping to shift the current account from a deficit of 4 per cent to a surplus of almost 7 per cent of GDP. However, the main export markets have remained the same¹² and the introduction of new products was limited. In addition, exports were concentrated in product categories and trading partners that grew more slowly than overall Slovenian exports during the period.¹³

Chart 3: Investment
(% of GDP)



Source: EUROSTAT

Chart 4: Corporate debt
(% of GDP)



* Corporate debt is calculated as a sum of debt securities, loans and other accounts payable.

Source: EUROSTAT and EBRD calculations

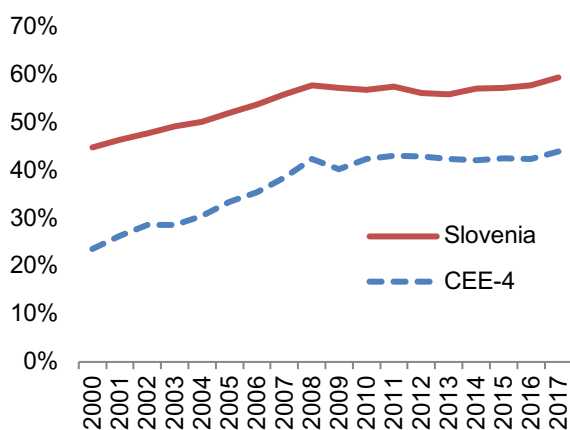
¹² The top 5 markets are Germany, Italy, Austria, Croatia and France.

¹³ For more detail, see IMF (2017), Republic of Slovenia Selected Issues, Country Report No. 17/126, p. 19-32.

Despite the recovery, investment has remained significantly below the 2008 level. A sharp drop in investment after 2009 was driven by investment in construction, machinery and equipment. While investment in other CEE-4 countries declined as well, it fell less and (relative to GDP) has been averaging around three percentage points higher than in Slovenia in recent years (Chart 3).

Corporate over-indebtedness might still be an issue. The rise in investment prior to 2008 was accompanied by an increase in corporate debt, which peaked in 2010 at around 107 per cent of GDP (Chart 4). Although the share of corporate debt in GDP fell to below 70 per cent at end-2017, the over-indebtedness¹⁴ might still be present to some degree. Specifically, in 2015, long-term debt of over-indebted companies was at around 12 per cent of GDP, much higher than in peer CEE countries (3 per cent), despite dropping by some 7 percentage points from the 2012 peak. The excess debt was concentrated in a small number of companies: one per cent of overleveraged companies (50 companies) held around 60 per cent of the debt.

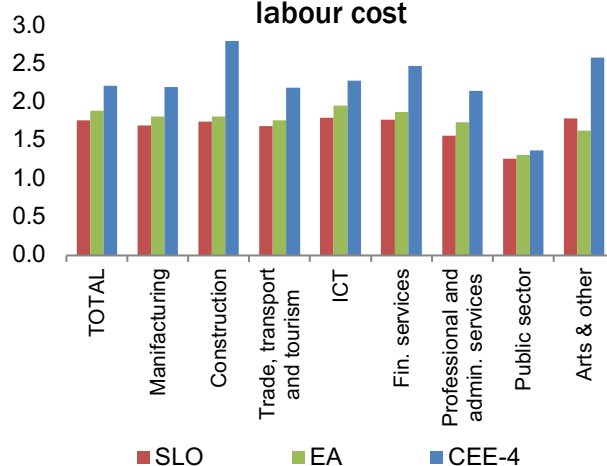
Chart 5: Value added per employee (EA=100%)



Source: EUROSTAT and EBRD calculations.

Productivity convergence has stalled. Labour productivity in Slovenia is high in regional terms but still below 60 per cent of the EA average. At around €38,000 in 2017, value added per employee in Slovenia is one-third higher than in CEE-4. However, convergence to EA levels has effectively stalled after the 2008 crisis (Chart 5). Even when taking into account lower (than in EA) nominal labour costs, Slovenia's competitiveness remains slightly below EA levels in almost all sectors. In addition, CEE-4 countries have a clear advantage over Slovenia in terms of value added per labour cost across all sectors (Chart 6).

Chart 6: Value added per €1 of labour cost



Source: EUROSTAT and EBRD calculations.

Competitiveness and governance are key drivers of productivity in Slovenia. An econometric analysis (see Annex 2 for more detail), using a large firm-level dataset, indicates that total factor productivity of Slovenian enterprises has fallen since 2009. The analysis also suggests that closing the still sizeable transition gaps in the competitive and well-governed qualities would have the largest benefits of all six qualities for productivity and growth. Improving the transition scores for green and resilient qualities would also be beneficial, while increasing inclusion (due to already relatively minor gaps) would have the least impact. Increasing the share of employees with tertiary education is vital for improving competitiveness, as is decreasing concentration, though the latter has a smaller effect. In the

¹⁴ A company is considered over-indebted if its long-term debt-to-EBITDA ratio is higher than 10. In order to better capture the effective level of over-indebtedness in a country, the long-term debt of over-indebted companies was augmented for

the long-term debt of companies with negative EBITDA and equity. Calculations are based on the ORBIS BvD data. For more detail, see Regional Economic Prospects in EBRD Countries of Operations (May 2017), p. 14-15.

area of governance, productivity would benefit from higher reliance on professional management, greater accountability of management to investors and boards of directors, and better-quality public institutions.

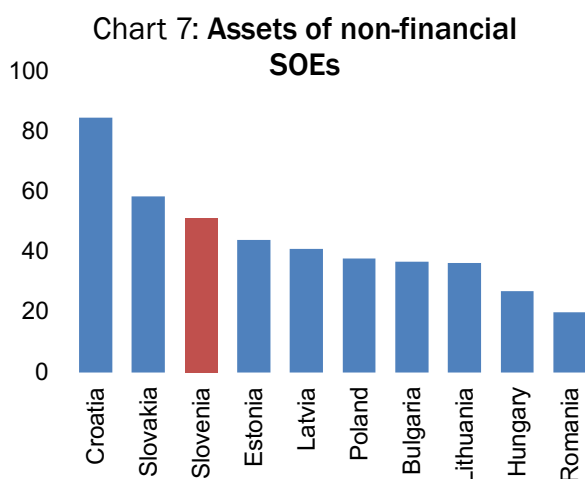
Reviving private sector productivity growth is key to further convergence of the Slovenian economy. As the working-age population is forecast to drop in the future, further catch-up in income levels will require faster productivity growth, which could be facilitated by improvements in the business environment to attract more (foreign) investment. The main issues to be addressed include the high share of state ownership, weak corporate governance, an insufficiently flexible labour market, skills mismatches and corporate over-indebtedness.

2.2. The still significant role of the state in the economy

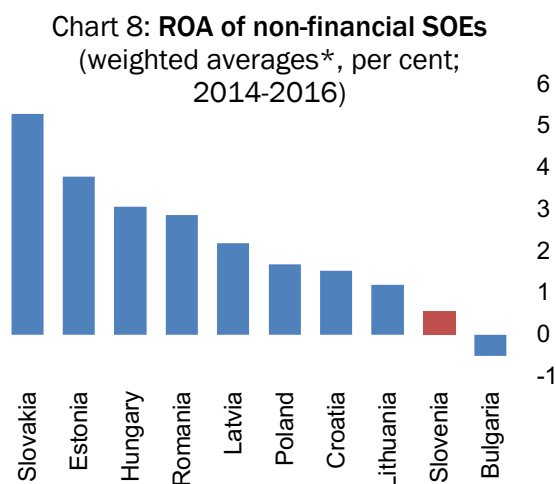
State involvement in the Slovenian economy is high. According to our estimates, Slovenia has the third highest share of non-financial SOE assets in GDP among CEE countries, at around 51 per cent (Chart 7). Adding financial companies raises the share to over 100 per cent of GDP. Public enterprises are present in many sectors (energy, transport, communications, banking, insurance, and even in manufacturing and tourism) because Slovenia, unlike other CEE countries, did not undergo a comprehensive privatisation process during the 1990s. In addition, internal buy-outs by managers and employees were explicitly favoured, which translated into insufficient incentives to restructure enterprises.

Slovenian SOEs are less profitable and productive than their private sector peers.¹⁵

Financial performance of these enterprises is low even by regional standards, as indicated by a very low average ROA in 2014-2016 (Chart 8). Although some progress has been made regarding the governance of SOEs since 2015, there is still much room for improvement.



Source: EBRD's calculation based on ORBIS BVD.



* weighted by shares in total assets

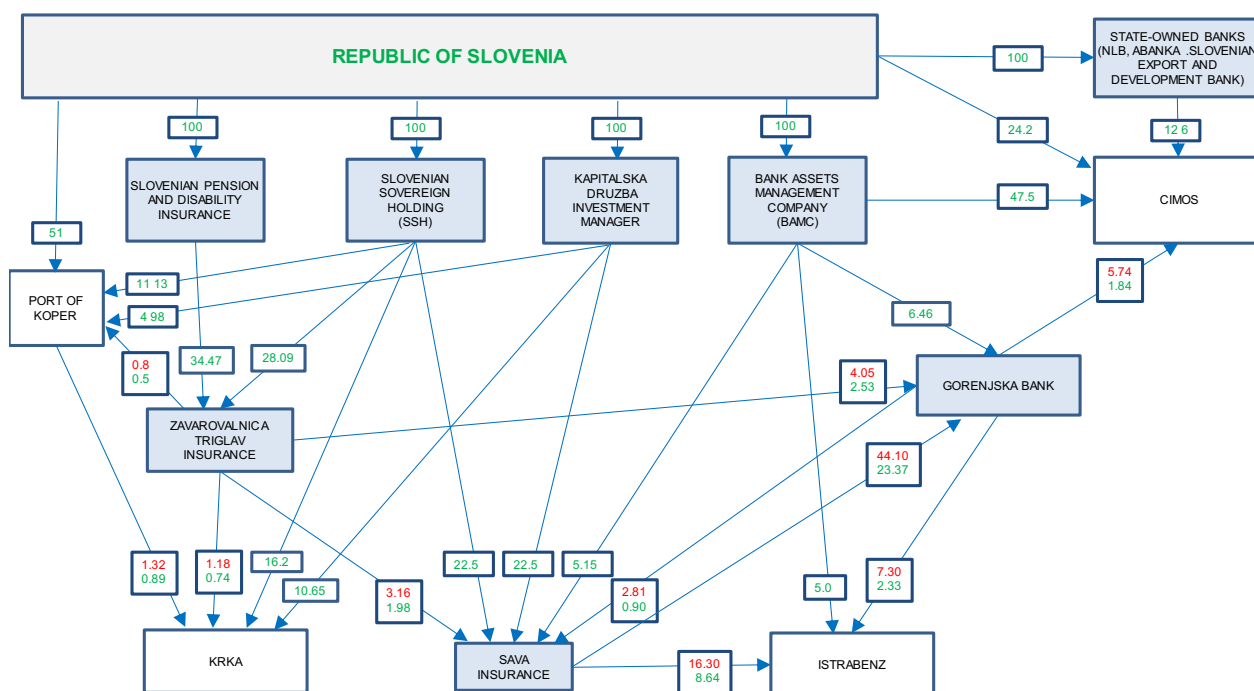
Source: EBRD's calculations based on ORBIS BVD.

¹⁵ For more detail, see the EC Country Report Slovenia 2015.

Cross-ownership of enterprises prevents efficient ownership control, resulting in their subpar performance. State assets are managed in a centralised manner, by the Slovenian Sovereign Holding (SSH) – a state entity established in 2014 charged with improving SOE governance and managing Slovenia’s privatisation programme. However, SOE ownership structures are often overly complex (Figure 1). Cross-ownership of companies is frequent, meaning that one entity owns another one and vice-versa, or that state ownership is fragmented.¹⁶ While interconnectedness of banks with poorly performing state enterprises had contributed to the excessive debt build-up before the crisis, cross-ownership also adds to governance problems and provides insufficient incentives to improve productivity.

Privatisation lags behind schedule. After the adoption of the state asset management strategy in July 2015, the focus of the SSH seems to have shifted away from privatisations to improvement of SOE corporate governance. The 2017 privatisation plan envisaged privatisation of 20 SOEs, including two major state-owned banks. However, only three enterprises were sold, despite the fact that majority of them were already in the 2016 privatisation plan. The flagship deals planned for 2017 – the sale of the country’s largest and third-largest banks, NLB and Abanka respectively – were delayed. After terminating the NLB sale procedure in June 2017, at end-2017 the government postponed the privatisation for 2018, while the privatisation of Abanka was moved back to 2019. In the last quarter of 2018, 59.1 per cent of the NLB was sold (with

Figure 1: An example of state cross-ownership in Slovenia



Notes: Based on Orbis BvD ownership data for 2015. Numbers in red represent direct ownership stake of a particular company in other company, while numbers in green show the percentage of state ownership - direct or indirect (e.g. the Slovenian state owns in total around 68 per cent of the Port of Koper, which in turn owns 1.32 per cent of Krka, meaning that state owns 0.89 per cent of shares in Krka via the Port of Koper). Light blue shading represents a financial sector company.

¹⁶ Some SOEs are owned by several state entities, each of them holding a minor stake, while the state as a whole holds a majority.

the rest staying in state hands) and Abanka has been put up for sale. The privatisation of the third largest SOE – telecommunications company Telekom Slovenije – has been pending since 2013 (without a timeline).

Strategic and important assets are likely to stay in state hands. In 2015 the government defined the range of ‘strategic’ (i.e., where the state is to preserve a majority stake) and ‘important’ assets (i.e., where the state is to preserve at least a 25 per cent stake) as well as portfolio investments (i.e., the state could sell them if needed/possible). Out of 102 SOEs, 45 were classified as either ‘strategic’ or ‘important’. The state plans to preserve majority stakes in natural monopolies and key infrastructure companies (such as roads, railways, ports), as well as “in cases when the operation of solely private providers of economic activity may cause disturbances in the market”.¹⁷ ‘Important’ companies are also rather widely defined as those providing “broader economic development” and holding “an important role in the integration of companies into supply chains and for the internationalisation of the economy”. Among the rest are systemic financial institutions, gaming and technology companies.

Apart from acting as a drag on growth, pervasive state ownership poses risks to public finances as well. Low profitability and relatively high indebtedness of SOEs raise fiscal risks through potential recapitalisation needs, as was the case in the banking sector. A smaller degree of state involvement in the economy and better corporate governance in SOEs could also contribute to better service provision to the private sector (e.g., in the case of utilities), more efficient resource allocation, and higher total investment and growth.

2.3. Heavy reliance on bank financing and underdeveloped capital markets

The Slovenian financial system is dominated by banks. Banks account for about 70 per cent of financial sector assets, while the rest is roughly equally divided between insurance companies on the one hand, and a group consisting of pension and investment funds and leasing companies on the other. The capital market may be considered underdeveloped given the country’s level of development. Stock market capitalization and trading volumes (in relation to GDP) are significantly lower in Slovenia than in EA or CEE peer countries, with the exception of the Slovak Republic (Chart 10).

Private sector credit is still contracting. As a consequence of recent crises, the economy witnessed rising NPLs, deleveraging and a contraction in lending, in particular to SMEs as the state first tackled NPLs to large corporates, transferring them to the BAMC. Despite the fact that the resilience of the Slovenian financial system has improved in the meantime and that NPLs fell to only 3 per cent of total loans in 2017 (from the September 2013 peak of 18 per cent), the share of private sector credit to GDP has still not recovered. At 45 per cent in 2017, this indicator is far below the EA and slightly below the CEE-4 average (Chart 9).¹⁸

¹⁷ For more detail, see the *State Assets Management Strategy*, available at: http://www.mf.gov.si/fileadmin/mf.gov.si/pageuploads/mediji/2015/State_Assets_Management_Strategy.pdf

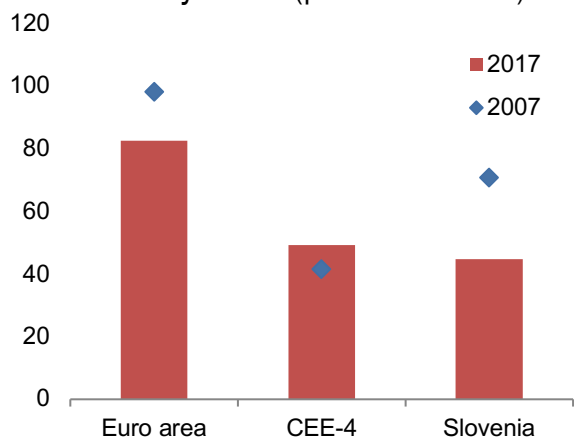
¹⁸ Before the banking crisis hit the country, private sector credit was significantly higher in Slovenia (around 80 of GDP in 2011) than in the CEE-4 region (50 per cent).

SMEs mainly rely on bank financing, which remains unfavourable despite recent improvements. According to the EC¹⁹, bank loans are relevant external source of financing for 51 per cent of SMEs in Slovenia, similar to the EU average (48 per cent). In 2017, access to finance was the most important concern for 7 per cent of Slovenian SMEs, equal to the EU average, and down from 28 per cent in 2014. However, the still high level of NPLs constrains their borrowing. For example, 28 per cent of Slovenian SMEs did not manage to get the full bank loan financing they had planned for during 2016 (vs. 17 per cent in the EU as a whole).

More equity financing is desirable, especially given the level of corporate over-indebtedness.

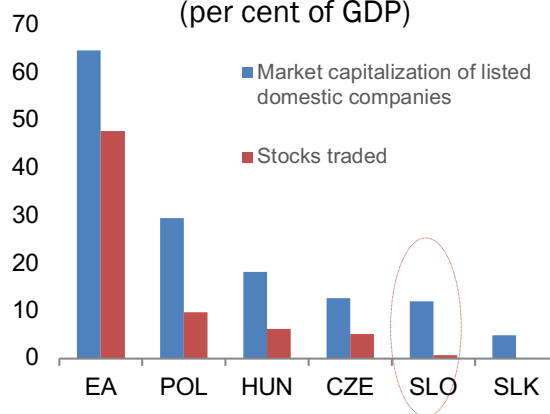
Private equity investments in Slovenia reached €73 million in 2016 (up from €12 million the year before). At 0.18 per cent of GDP, these investments were above the CEE average (0.12 per cent), but well below the EU average (0.33 per cent).²⁰ Only a small fraction of investment (4 per cent) was related to venture capital, while the remainder comprised buyouts. Interestingly, equity financing, according to the EC, is relevant for one third of SMEs in Slovenia – much more than in the EU as a whole (only 13 per cent).

Chart 9: Domestic credit to private sector by banks (per cent of GDP)



Source: WB World development indicators.

Chart 10: Stock market (per cent of GDP)



* Data relate to 2016 except for Slovakia (2013), and EA and Czech Republic stocks traded (2014).

Source: WB, ECB, IMF and EBRD's calculations.

¹⁹ 2017 Survey on the Access to Finance of Enterprises (SAFE)

²⁰ Europe Invest data (<https://www.investeurope.eu/>).

3. Qualities of a sustainable market economy

Slovenia faces gaps in two out of six transition qualities²¹ (see Chart 1). While the country compares very well to the benchmark of advanced economies in terms of green, inclusive and integrated qualities, it lags behind in the areas of:

- Well-governed,
- Competitive, and
- Resilient.

The following pages provide a more detailed overview of transition qualities in Slovenia.

1. Competitive [ATQ = 7.21]

40th out of 190 countries in ease of doing business (World Bank, 2019)

35th out of 140 countries in Global Competitiveness Index (WEF, 2018)

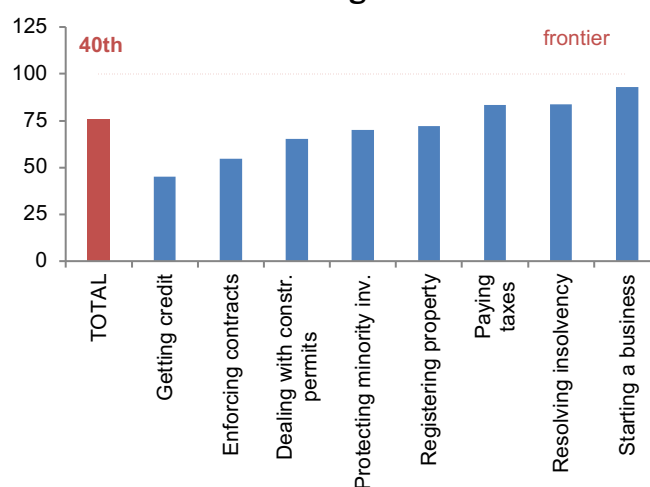
32nd out of 127 countries in Global Innovation Index (Cornell University, INSEAD and WIPO, 2017)

Ranked **2nd** among EBRD's CoOs on the ATQ Competitive

Since its independence in 1991, **Slovenia has become one of the most competitive EBRD countries of operation.** However, the 2008 global crisis exposed important structural weaknesses. The high level of state involvement in the economy, restrictive labour regulations and red tape harm the business environment and investment.

- **Public ownership and control of enterprises** are widespread (energy, transport, communications, banking, insurance, etc.). Enterprises controlled by the state are estimated to account for 18 per cent of the corporate sector's total assets. The government has made some progress on privatisation but more needs to be done.
- Despite a relatively good global standing in the World Bank **Doing Business** report, Slovenia ranks in the lower half of EA countries, with significant variations in rankings across different dimensions and particularly low scores in Enforcing Contracts and Getting Credit.

Ease of doing business



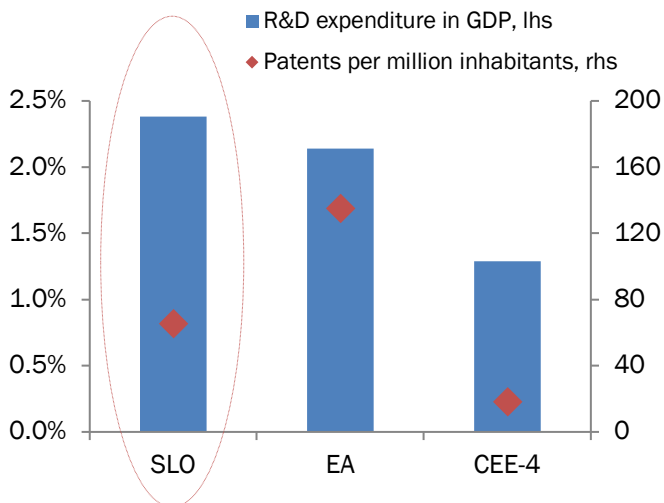
Source: World Bank Doing Business 2019

- Other challenges relate to **public administration inefficiencies, inflexible labour market and restrictive product market regulations.** Similarly, tax rates and regulations, inefficient government bureaucracy and restrictive labour regulations are seen as the most problematic factors for doing business by World Economic Forum survey respondents.

²¹ For a brief overview of the main characteristics of transition qualities see Annex 1.

- **Access to finance**, according to the EBRD's BEEPS V (2013), was among the top three obstacles in the business environment, but more recent surveys indicate it has become a less serious issue. Although banks' balance sheets have been repaired relatively fast after the 2012-13 banking crisis, NPLs to SMEs are still high, hindering SME lending.
- The **education system** is of good quality (Slovenia ranks 29th in the WEF's Quality of education). Still, the skills of graduates do not fully match the needs of the private sector.
- Despite high R&D expenditure (2.4 per cent of GDP in 2014), **innovation** is limited as evidenced by, e.g., the relatively low number of patent applications to the European Patent Office per million inhabitants (66 in 2014 vs. the EU average of 112). Knowledge economy could be boosted by privatisation, improvement in the overall business environment, more FDI, and stronger framework for entrepreneurship and venture capital.

Innovation



Source: EUROSTAT

2. Well governed [ATQ = 6.63]

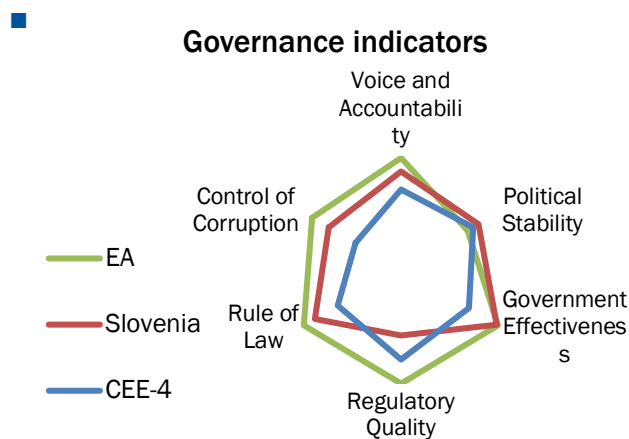
34th out of 180 countries in Corruption Perceptions Index (Transparency International, 2017)

122nd on burden of government regulation out of 140 countries (WEF's Global Competitiveness Index, 2018)

Less than one third of Slovenian respondents think there is law and order in the country (LiTS III, 2016)

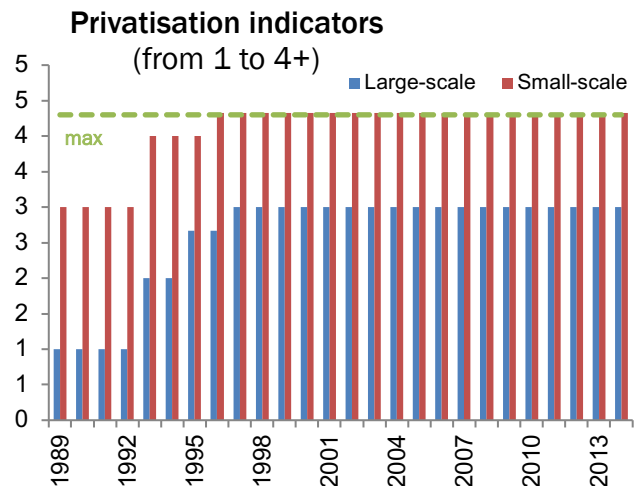
The average female Board representation within the largest listed companies is around 23 per cent vs. 30 per cent minimum in EU countries from 2015

Slovenia lags behind other EA countries on most aspects of public governance. The country scores particularly low in the area of regulatory quality. SOEs are managed by the Slovenian Sovereign Holding (SSH). Privatisation continues to be met with social and political resistance.



Source: World Bank's Worldwide Governance Indicators 2017

State ownership remains high. The 2017 privatisation plan envisaged the sale of 20 SOEs, including Slovenia's largest and third-largest bank (NLB and Abanka, respectively). However, the majority of companies remain to be sold. The absence of more ambitious steps towards privatisation could further increase the pressure on public finances (public debt is around 74 per cent of GDP).



Source: EBRD transition reports

- The **corporate governance** framework is relatively advanced compared to other transition countries but needs strengthening in the areas of structure and functioning of boards, internal control and shareholder rights.²² In addition, the complex SOE ownership structures are contributing to less effective control and weaker management performance.
- Despite the country's good score on the Corruption Perception Index, more than seven out of ten citizens in Slovenia believe that the government is not decisive in fighting **corruption**, the second most critical result in the EU (Global Corruption Barometer 2016).

²² For more details, see Cigna, G.P., Kobel, Y. and Sigheartau, A. (2016): Corporate Governance in Transition Economies: Slovenia Country Report, EBRD.

- Corruption risks are high in **public procurement**, which accounts for around 13 per cent of the country's GDP. According to the EC, almost 40 per cent of the contracts in 2015 had a single bid and one-fifth followed non-open tenders. However, key anti-corruption reforms have been adopted and are being implemented. The government is also participating in a pilot initiative "Integrity Pacts – Civil Control Mechanism for Safeguarding EU funds against Fraud and Corruption".
- **Public administration** is undergoing a significant reform. In 2015 the government adopted a five-year development strategy to modernise the public administration by improving its efficiency, transparency and the quality of services.

Green [ATQ = 7.27]

Slovenia's green targets by 2020²³:

20 per cent improvement in energy efficiency (to 5.1 Mtoe expressed in final energy consumption)

25 per cent of energy from renewable sources in gross final energy consumption (from 22 per cent in 2015)

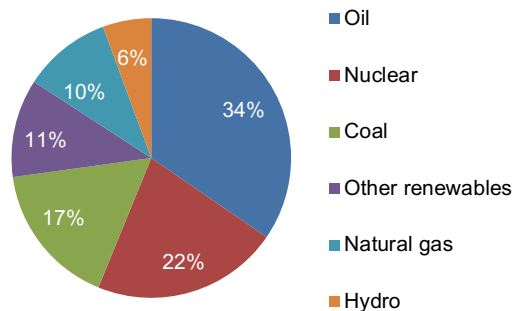
50 per cent municipal waste recycling target (already reached)

Transition to a green economy is considered one of Slovenia's strategic objectives. The country is on track with its renewable energy targets and has already met municipal waste recycling targets. However, to fulfil the Accession Treaty obligations, closer monitoring and enforcement in areas such as energy efficiency, air quality and urban waste water treatment is needed. Illegal landfills are also an issue.

- The country is not rich in **energy resources**. 22 per cent of primary energy supply comes from the country's sole nuclear plant. In the long term, renewable energy sources should replace coal and lignite as well as the country's nuclear plant (Krsko), which is scheduled to close by 2043.
- The most important **renewable energy** sources in Slovenia are wood and water. The country is planning to build 10 new hydro power plants on the Sava River. In order to meet EU-mandated emissions requirements, the government is expected to increase incentives and investment in solar technology.

- Slovenia's **energy intensity** has been decreasing, but is still almost 50 per cent higher than the EU average. The most energy-intensive is the transport sector, followed by the industry and residential sector. The national energy efficiency action plan envisages priorities in these sectors (e.g., introducing low-carbon technologies, ensuring that all new public sector buildings are nearly zero-energy from 2018, and others from 2020).

Total primary energy supply by source



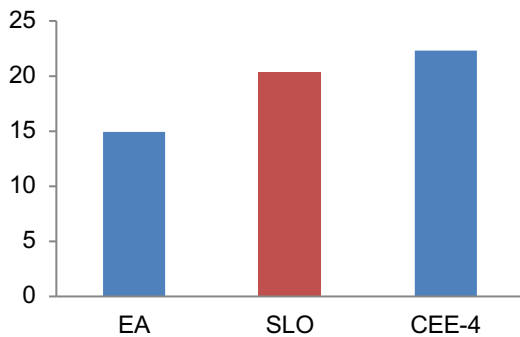
Source: International Energy Agency

- Slovenia has made very good progress in the area of **waste management**. The country recycled 54.1 per cent of its waste in 2015, putting it in third place in the EU. However, it is lagging behind implementation of the Urban Waste Water Treatment Directive, with only 33.9 per cent of the waste water load collected subject to more stringent treatment in accordance with Article 5 of the Directive. Furthermore, water loss from the public water supply currently runs at 30 per cent due to poorly maintained networks.

²³ EU green targets that national targets are expected to meet by 2030 are 30, 27 and 65 per cent, respectively.

- **Air quality** in Slovenia continues to give rise for concern. The concentration of PM2.5 particles has increased by almost 30 per cent since 2010, while the health-related external costs from air pollution in Slovenia are around €990 million/year. The largest PM2.5 emission sources are wood-burning residential plants and road transport. PM concentration needs to be curbed through enhancing efficiency in the energy and transport sectors, and a comprehensive strategy is needed to address this problem.

PM2.5 air pollution (mg per cubic meter)



Source: World Bank

Inclusive [ATQ = 7.97]

Employment rate of older (55-64 years) is 43 per cent (vs 57 per cent in EA)

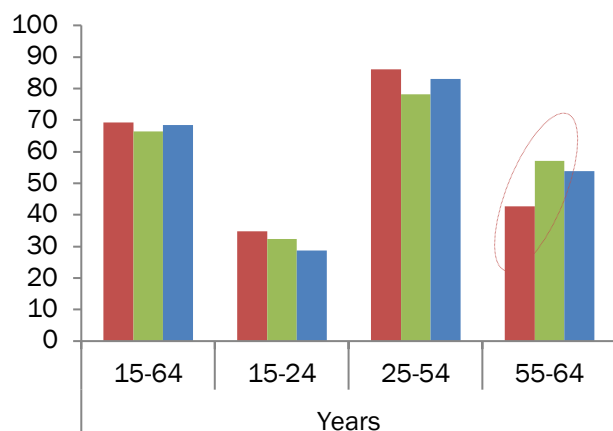
Among older, employment rate is lower for women than men (38 vs 48 per cent)

9 per cent of part-time employed (vs. 21 per cent in the EA)

Gender pay gap is among the lowest in the EU (8.1 per cent vs EU average of 16.3 per cent; EUROSTAT, 2015) but labour force participation remains lower for women than men (54 vs 63 per cent; WB, 2017)

Despite favourable labour market developments in recent years, the labour market is still not sufficiently flexible and inclusive. The unemployment rate fell from 10.1 per cent in 2013 to 6.6 per cent in 2017. Although unemployment is somewhat higher among females, the most vulnerable (somewhat overlapping) groups are considered to be older and low-skilled workers; increasing their employability presents the major inclusion challenge in Slovenia. Part-time employment is also significantly lower than the EA average.

Employment rate by age group (%)



Source: EUROSTAT

■ SLO ■ EA ■ CEE-4

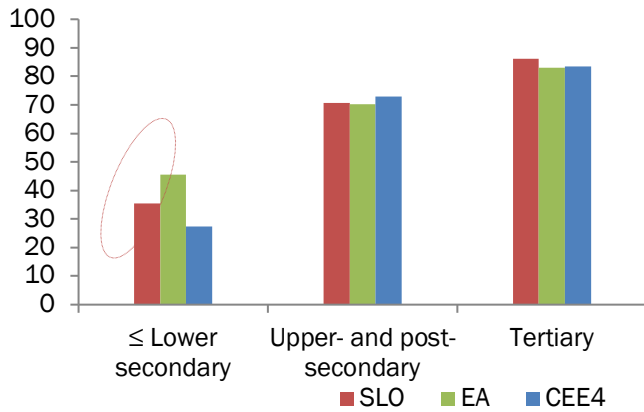
- Despite the labour market reform in 2013, **older people** still face obstacles in staying active in the market. At 43 per cent, the employment rate of older (55-64 years) is the 4th lowest in the EU.²⁴ Employers doubt their skills and capabilities and see them as less flexible and more expensive (older workers are subject to high seniority bonuses, raising their employment costs by around 15 per cent compared to other workers). The gender gap to the detriment of women is small.
- Older people are also more likely to be **long-term unemployed** (12 months or more). Close to 60 per cent of all long-term unemployed are older than 50. The share of long-term unemployment in total unemployment has increased to over 50 per cent in 2016 (from 30 per cent in 2009) but fell somewhat in 2017.
- **Low-skilled** workers comprise 30 per cent of registered unemployed population. The high share is partly a consequence of a significant decline in economic activity in the construction and manufacturing sectors after 2008.
- The process of rapid **population ageing** (the average age of the population rose from 35.9 years in 1991 to 42.4 years in 2014) increases the demand for a lifelong learning and calls for training programmes for older workers and retraining of the unemployed. It also poses a major risk for long-term fiscal sustainability.

²⁴ Gallup World Poll (2013-2016) surveys also show that older people are substantially less likely to be employed compared to prime working age

population : 45 per cent (people aged 50-65 years) vs. 78 per cent (those aged 25-49 years).

- Despite good **tertiary education** attainment rate (46.4 per cent of 30-34 year-olds vs. 39.9 per cent in the EU), the gender gap is the widest in the EU in 2017, with 58.8 per cent of women and only 34.7 per cent of men attaining higher education.

Employment rate by education (%)



Source: EUROSTAT

Resilient [ATQ = 7.80]

Public debt is at **74 per cent** of GDP (end-2017)

External debt is at **102 per cent** of GDP (end-2017)

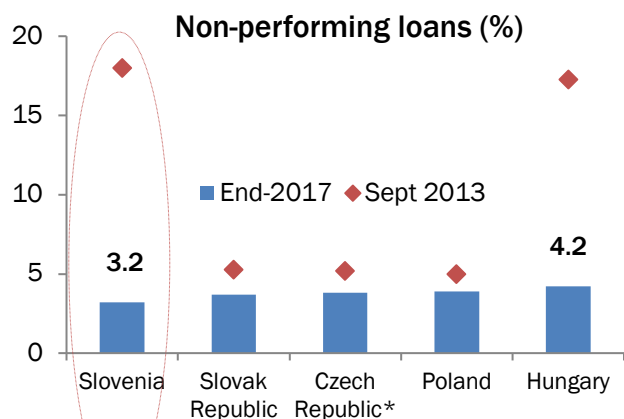
Capital adequacy ratio is at **18.2 per cent** (end-2017)

NPLs are at **3.2 per cent** (end-2017)

2nd out of 125 countries in energy security (World Energy Council, 2017)

Despite the return to growth, the recovery is slow, with legacies of the crisis still present.

Macroeconomic stability has improved thanks to the fiscal adjustment and strong exports. Public debt declined in 2016 for the first time since 2008 but is still high, and fiscal reforms are needed to keep it on a downward path. EU and EA memberships underpin the resilience of the economy, acting as a backstop for financial stability concerns. The main external vulnerability relates to high external debt (102 per cent of GDP at end-2017).

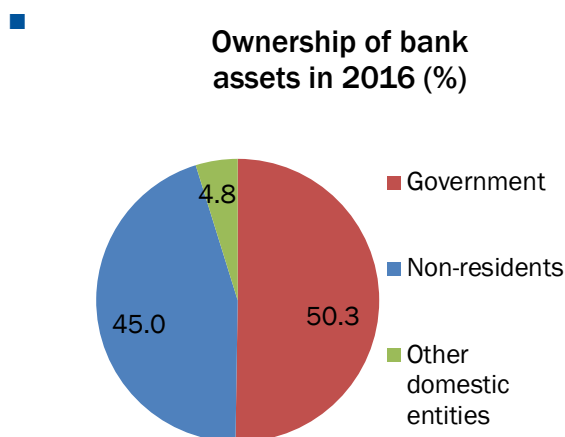


* Q3 2017

Source: IMF

■ **Financial stability** improved in the aftermath of 2012-2013 banking crisis, with nationalisation and capital injections into the largest Slovenian banks. NPLs have come down significantly, on the back of transfers to the BAMC and banks' internal efforts, and their provision coverage has improved. However, non-performing exposure to SME is still high (14.0 per cent in March 2018), hindering their access to finance. Similarly, despite the ongoing deleveraging, the over-indebtedness of the corporate sector is worrisome, and state ownership of large parts of the banking system inhibits a more robust credit expansion and recovery

■ The **banking sector** is well-capitalised and very liquid, but with notable differences in capital adequacy between banks. Credit growth to the corporate sector turned positive in 2017, after six years of decline. Weak (though improving) profitability poses a challenge given the low interest rate environment, lacklustre credit growth and limited space for further cost optimisation. While the shift from foreign financing towards retail deposits supports resilience, funding from long-term instruments is still negligible, contributing to maturity mismatches.



Source: Bank of Slovenia

Private sector credit stands at around 45 per cent of GDP, implying **moderate banking penetration**. Non-banking financial services such as leasing, factoring and insurance are relatively well-developed. Capital markets remain underdeveloped.

- Slovenia is among the top performers globally on **energy security**, despite full import dependency in gas and liquid fuels while the import and export of electricity is relatively balanced. Increasing the share of renewables in energy sources would contribute to further reduction of energy import dependency (around 45 per cent).
- Vulnerability to **climate change** relates to the higher incidence of extreme weather conditions (floods, drought), sea-level rise (approx. 4 mm a year), a modified precipitation regime, and a potential decrease in water availability.

Integrated [ATQ = 7.44]

EU member since 2004

EA member since 2007

1st out of 190 countries on trading across borders (World Bank Doing Business, 2018)

35th out of 140 countries on the quality of infrastructure (WEF, 2018)

50th out of 160 countries on International Logistics Performance Index (World Bank, 2016)

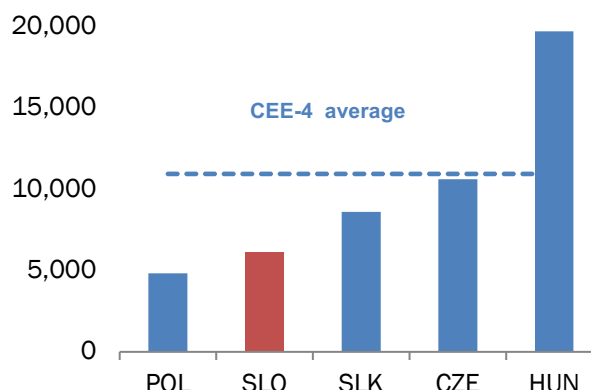
Net FDI to GDP stood at 1.0 per cent in 2017

An EU and EA member, Slovenia is a well-integrated economy in terms of trade and energy, but less so in terms of investment.

Benefitting from its favourable geographical position and access to the EU common market, the country is deepening its integration into global (and especially regional) supply chains. Export performance has been strong in the last ten years, although Slovenia's exports show somewhat higher product concentration compared to other European countries. The stock of FDI remains low.

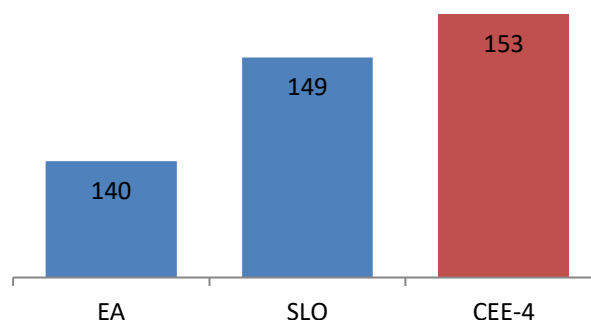
- The country's **trade openness**²⁵ is high (almost 150 per cent of GDP in 2015-17), above the EA average although slightly below the CEE-4 level. Exports comprise around 80 per cent of GDP, with the top five categories being vehicles, electrical machinery, general machinery, pharmaceuticals, and fuel. The external position of Slovenia has strengthened significantly over the past decade, with the trade balance in goods and services growing into a surplus of around 10 per cent of GDP in 2017 (compared with a 2 per cent deficit in 2008).

Inward direct investment per capita (USD)



Source: IMF CDIS, World Bank and EBRD calculations

Trade openness (% of GDP)



Source: World Bank's World Development Indicators

- On the other hand, Slovenia is not widely recognised as an attractive **investment** location. At around US\$ 6,000 in 2015, inward direct investment per capita was only 55 per cent of the CEE-4 average. Low foreign involvement in the economy could be explained by the reluctance to sell assets to foreigners in order to defend "national interests", but also by high labour costs and taxes, payment indiscipline and inflexible labour market regulations.

²⁵ (Exports + Imports of goods and services)/GDP.

- The country ranks well globally in terms of **quality of transport infrastructure** and is above the EBRD CoOs average, with higher scores in all four categories (rail, road, water and air). However, investment in transport infrastructure decreased significantly over 2010-2016 and investor perception about its quality (especially of rail infrastructure, transport and flight connectivity) deteriorated substantially.
- Slovenia's **energy network** (gas and electricity) is well integrated with regional markets (Austria, Croatia, Italy and Hungary). Electricity interconnection capacity stands at 85 per cent of installed production capacity, and ongoing investment in electricity and gas infrastructure will further enhance market integration, but also competitiveness and security of supply.

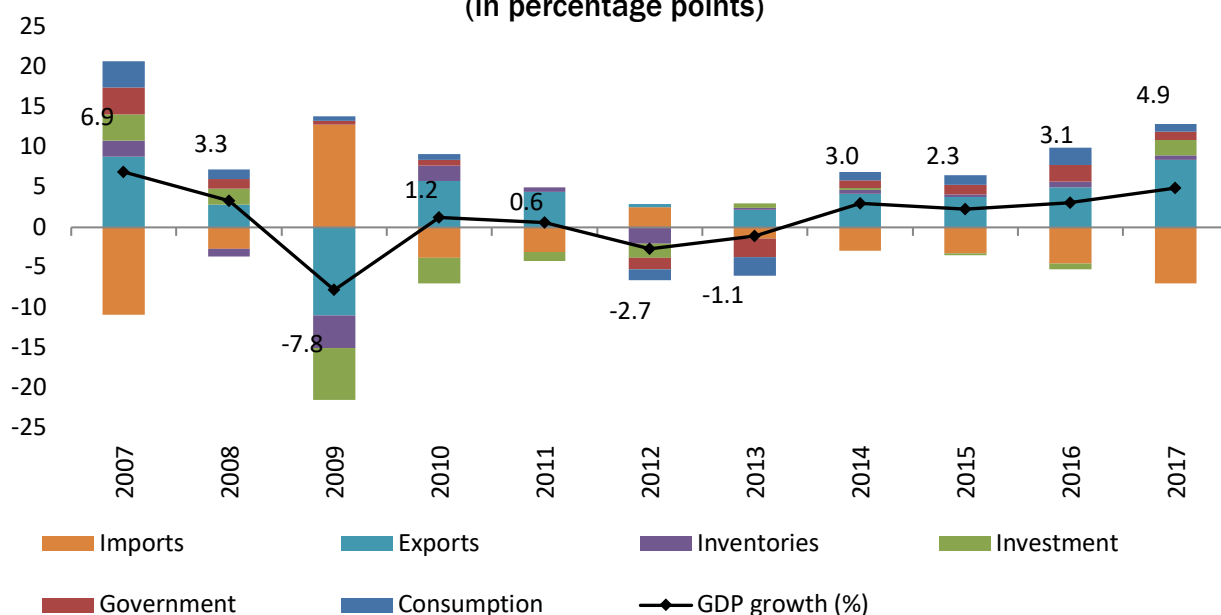
Economic Outlook

After the crises in 2008-2009 and 2012-2013, Slovenia has recorded a steady recovery in the last four years. Since 2014, both domestic demand and net exports have contributed positively to GDP growth, although rising imports have been cancelling out most of the positive contribution of exports (Chart 11). The economy expanded strongly in 2017, by 4.9 per cent (up from 3.1 per cent in 2016), on the back of growing investment, private consumption and exports. However, the growth rate is likely to moderate in the short run. Slovenia's economy is projected to grow more slowly in 2018 and 2019 (at 4.2 and 3.3 per cent, respectively), as the economy reaches its potential. The downside risks come from possibly weaker demand from Slovenia's main trading partners and slow structural reforms and privatisation. On the other hand, a stronger than envisaged government investment cycle and growth in private consumption could push up short-run growth rates above projections.

The medium-term growth outlook will depend on the speed of structural reforms, which have progressed but have not been completed.

Fiscal consolidation resulted in the budget deficit falling from 5.5 per cent of GDP in 2014 to a 0.1 per cent surplus in 2017, with the country exiting the EC's Excessive Deficit Procedure in 2016. However, many of the measures introduced were of a one-off nature. Similarly, despite starting to fall last year, public debt remains high at 73 per cent of GDP in mid-2018. There is a need for structural reforms in areas such as a sustainable public wage system motivating employees, and also in other areas linked to the ageing of the society, including pensions, health care, long-term care and education (especially life-long learning). Following the banking crisis in 2012-13, a large proportion of corporate NPLs have been transferred to the BAMC, improving the stability and operation of the banking sector, but banks still hold significant bad portfolios in relation to SMEs.

Chart 11: GDP growth and its structure (in percentage points)



Source: National statistical office.

Political background

The composition of the new government following early elections on 3 June 2018 was marked by lengthy coalition-building, as the party that won the plurality of votes could not secure a majority support required to form a government. On 13 September 2018 Parliament approved the new wide centre-left minority coalition government put forward by the leader of the second-placed centrist party, Marjan Sarec. The governing coalition includes: Marjan Sarec List (LMS), Modern Centre party (SMC), Social Democrats (SD), Alenka Bratusek Party (SAB) and Pensioners Party (DeSUS) – securing 43 out of 90 votes. The five government political parties signed a coalition agreement on 29 August and initiated an agreement on cooperation with the Left (partnering party outside the government, securing an additional 9 votes), which has also participated in setting the guidelines for the government's economic and financial programme. The minority government is a precedent in Slovenian political history, and intense negotiations between the governing parties and the Left are expected in this mandate.

The orientation of the economic strategy of the new government is an economically successful Slovenia, focused on sustainable development and environmental protection. They have pledged to boost economic growth, uphold the rule of law and ensure a stable and predictable environment. The coalition agreement is to a certain degree a compromise and a combination of fairly different economic and financial strategies of the political parties which make the new coalition. Given that the government is aiming to comply with the golden rule of fiscal discipline, it is yet to be seen which measures will secure the necessary support for implementation.

Annex 1: Characterising qualities of sustainable market economy

In establishing the provisional ATQ scores the following characteristics under each of the qualities were considered.

1) Competitive – The assessment of economic competitiveness draws on the existing assessments of transition challenges relating to market structures that support competition and incentives for sound decision making (including measures of openness, business skills and the business environment). It also takes account of the capacity of firms to add value and innovate (including measures of access to appropriate infrastructure and resources).

2) Well-governed – The assessment of the extent to which an economy is well-governed builds on the existing EBRD assessments of corporate governance for private enterprises, complemented by a measure of integrity and business standards in that regard. In addition, the assessment incorporates measures of the quality of public governance, the integrity and control of corruption and the rule of law based on the available external sources such as, for instance, the World Governance Indicators compiled by the World Bank.

3) Integrated – The assessment of economic integration takes into account both cross-border and domestic connectivity aspects. It uses measures of openness to trade and investment, as well as balance of payment aspects. In addition, it looks at the quality of cross-border and domestic infrastructure, including considerations of cost and service provision. Measures of the quality of energy and ICT infrastructure are also included as important pillars of a modern market economy.

4) Resilient – The assessment of challenges in the area of stability and economic resilience take into account two dimensions of stability. With regard to financial stability, it draws on existing assessments of transition challenges in financial sectors. Given the importance of the banking sector vis-à-vis other financing sources, most indicators relate to the health and adequate regulation of the banking sector. However, other sources such as stock markets are also taken into account. The second component is energy sector resilience which mainly looks at domestic and cross-border connectivity but also takes into account legal and regulatory considerations in the electricity and gas markets.

5) Green – The assessment of challenges in the area of green economy builds on the assessment done for the sustainable resource initiative (SRI). It uses some of the existing indicator, for example, relating to carbon intensity or the extent of renewable energy in the energy mix. It also continues to look at pricing and the legal or policy framework. Furthermore, the assessment takes into account measures of climate mitigation and adaptation as well as environmental outcome indicators such as air pollution, waste generation and biodiversity.

6) Inclusive – The assessment of inclusion challenges is closely aligned with the existing methodology for assessing transition gaps in the areas of inclusion and equality of opportunity, with particular reference to gender gaps, regional gaps, and gaps in terms of opportunities for young people.

Annex 2: Methodology and results of the corporate sector productivity drivers exercise

In order to estimate the total factor productivity (TFP) drivers of Slovenian firms, a two-step approach was applied. In the first step, following the empirical literature on total factor productivity²⁶, firm level data from ORBIS were used to estimate productivity in the following regression:

$$y_{it} = \alpha_k k_{it} + \alpha_l l_{it} + \alpha_m m_{it} + \varepsilon_{it}$$

where i and t refer to firm i and year t ; y_{it} , k_{it} , l_{it} and m_{it} represent the logarithm of a firm's output (sales) and its production inputs: capital (measured as the book value of fixed assets), labour (number of employees) and material costs, respectively. The TFP was computed as a residual. The Levinsohn-Petrin²⁷ correction (i.e. material inputs are used as a proxy to control for

unobservable productivity shocks) addressed the endogeneity.

In the second step, firm-level productivity estimates from the first step and a variety of firm-specific, macroeconomic, institutional and business environment determinants (see Table 2) were used to identify the key drivers of productivity growth using Arellano-Bond dynamic panel estimation.

Summary of results is presented in Table 1. In order to compare the size of influence of significant variables on TFP, standardised coefficients were used. Furthermore, the variables are classified according to the transition quality they represent.

Table 1: **Drivers of total factor productivity by transition quality and size of impact**

Competitive	Well-governed	Green	Resilient	Inclusive
Employees with tertiary education in total employment	Professional management	Energy efficiency	Macroeconomic environment	Share of females in employment
Concentration	Efficacy of corporate boards		NPLs	Share of youth in employment
	Quality of institutions			

Standardized coefficients

≥ 0.3
0.2-0.3
0.1-0.2
≤ 0.1

* Darker shades indicate higher relative importance of the variables, i.e. higher standardized coefficient (showing the impact of one standard deviation change in the variable on productivity; calculated by multiplying estimated coefficient by the ratio between the standard deviations of independent and dependent variable).

²⁶ See e.g. Wooldridge, J. M. (2009): On Estimating Firm-level Production Functions Using Proxy Variables to Control for Unobservables. *Economic Letters*, 104(3), pp.112-114; Gal, P. (2013): Measuring Total Factor Productivity at the Firm Level Using OECD- ORBIS, *OECD Economics Department Working Paper*, No. 1049; Escribano, A. & Pena, J. (2009): International productivity assessment of the Spanish investment climate: Analysis based on firm level data, mimeo; Añón-Higón, D., Manjón-Antolin, M., Mañez, J. A. & Sanchis-Llopis, J. A. (2014): Does

R&D protect SMEs from the hardness of the cycle? Evidence from Spanish SMEs (1990-2009). *International Entrepreneurship and Management Journal*, 11(2), pp.361-376.

²⁷ Levinsohn, J. & Petrin, A. (2003): Estimating production functions using inputs to control for unobservables. *Review of Economic Studies*, 70(2), pp.317-341.

Table 2 **Description of the variables**

<i>Variable</i>	<i>Definition</i>	<i>Source</i>
energy_efficient	Ratio of greenhouse gas emissions and gross value added (GVA) in the sector	EUROSTAT
institution_quality	Quality of public institutions (property rights, ethics and corruption, undue influence, government efficiency and security) and private institutions (corporate ethics and accountability)	WEF GCI
efficacy_corporate_boards	Efficacy of corporate boards, 1-7 (best)	WEF GCI
female_participation	Share of females in total employment in the sector	Statistical Office of the Republic of Slovenia
macroeconomic_environment	Quality of macroeconomic environment (inflation, fiscal deficit, public debt, gross national savings and the country's credit rating)	WEF GCI
youth_employment	Share of youth population (15-24) in total employment in the sector	Statistical Office of the Republic of Slovenia
npl_sector	Ratio of bank non-performing loans and total gross loans to corporates in the sector	National Bank of Slovenia
concentration	Share of top 5 companies in the sector in total sectoral revenues	ORBIS
professional_management	Reliance on professional management, 1-7 (best)	WEF GCI
tertiary_edu_in_total_employment	Share of employees with tertiary education in total employment in the sector	Statistical Office of the Republic of Slovenia

An aerial photograph of a coastal town, likely in Slovenia, showing a dense cluster of buildings with terracotta roofs, a harbor with many boats, and a hillside with more buildings and trees in the background. The entire image has a teal color overlay.

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