

Chapter 3

Foreign investment, governance and economic performance

Slovenia's productivity levels have converged rapidly towards the euro area and OECD averages since it began the transition to a market economy in the early 1990s. However, a gap of 30% in aggregate productivity remains vis-à-vis the upper half of OECD countries and productivity is low in a number of industrial sectors with high public ownership or low foreign ownership. The somewhat skewed pattern of asset ownership in the country is related to past government policies that either directly or indirectly favoured domestic public and private investors. For example, Slovenia's initial privatisation programme favoured existing internal stakeholders, there was limited privatisation of public utilities and the two state-owned investment funds were allowed to acquire blocking shares in many of the country's largest private firms. Foreign investment has also been deterred by labour market institutions that have raised the relative unit cost of employing workers compared to some other transition economies. As part of accession to the OECD, the Slovenian government agreed to improve the transparency with which the state's asset holdings are managed by creating a new central ownership agency. The new agency will manage all the state's direct and indirect asset holdings, outline a plan for disposing of any assets for which it considers public ownership to no longer be necessary and put in place an effective corporate governance regime for managing the assets that remain in public hands. To ensure that government ownership policies contribute to encouraging greater involvement of foreign investors, more competitive domestic markets and more enterprise restructuring, the new central agency will need to be fully independent of government, grasp the opportunity to rationalise the state's asset holdings through greater privatisation and significantly improve the governance of state-owned enterprises. Greater foreign investment would also be facilitated by making the tax system simpler and more neutral, reducing the administrative and regulatory burden on foreign investors and easing employment protection legislation.

Over the past two decades Slovenia has made a successful transition from a planned to a market based economy. A unique aspect of Slovenia's transition is the method by which the privatisation of previously socially-owned assets took place. Unlike most other transition economies where the state initially dominated the economy's ownership structure, Slovenia, as part of the former Yugoslavia, had a quasi-market system based on partially independent enterprise level management. The privatisation process built on this existing structure by giving a prominent role to managers, workers and pensioners within a widely dispersed ownership structure. The state also maintained a central role in the economy through its direct ownership and control of enterprises in network industries and the financial sector, as well as indirect influence over "strategic" enterprises across all sectors of the economy through the state-owned pension and restitution funds.

Slovenia's gradualist approach to privatisation and broader economic reforms had the benefit of limiting the initial shock to employment and enterprise structures and helping to maintain social stability. Consequently, there has been relatively little backlash against the reform process compared to some other transition economies and Slovenia has achieved strong and stable growth for most of the transition period. Today, Slovenia remains the most prosperous of all the Central and Eastern European transition economies. However, the gradualist approach to reform has bequeathed weaknesses in the business environment that have become even more apparent in the aftermath of the global financial crisis. Dispersed ownership has made it more difficult to restructure large inefficient enterprises. The state's ownership share is one of the highest in the OECD and it indirectly controls many of the country's largest listed companies. Moreover, the state also has not always been an effective shareholder. These features have inhibited productivity growth and foreign investment in the sectors the state most heavily influences.

Previous chapters have outlined some of the reforms that are necessary to improve Slovenia's competitiveness within the euro area, the sustainability of public finances, the stability of the financial system, the functioning of the labour market and the performance of the higher education system. This chapter complements this analysis by probing the nexus between the state's ownership policies, corporate governance, foreign investment and productivity. It begins by documenting sectoral productivity trends over the past decade, identifying those sectors where there may be the most room to lift performance. It then outlines the key policy sensitive factors inhibiting faster productivity growth in these sectors. The chapter argues that greater foreign direct investment (FDI) is an important channel through which the government's ownership policies and the corporate governance framework have affected economic performance in Slovenia and identifies some priorities for reform that build on existing government plans.

There is scope to significantly raise labour productivity across all sectors of the economy

In the decade leading up to the global financial crisis, Slovenian living standards converged rapidly towards the euro area average and reached a level of around 70% of the upper half of OECD countries in 2009. GDP per capita grew at an average annual rate of 4.2% between 1998 and 2008, more than twice the euro area average and, amongst OECD European countries, exceeded only by Poland and the Slovak Republic. At a sectoral level, there was considerable variation in labour productivity performance over the same period (Table 3.1). While value added in the business sector also grew at just over 4% per annum, labour productivity growth in the medium and high-technology manufacturing sector grew at twice this rate, leading to a 3 percentage point increase in that sector's share of value added. In contrast, labour productivity growth in the rapidly growing construction sector was only around 1.5% per annum and growth in agriculture was also weak. Value added per worker in 2008 was highest in the capital intensive utilities and telecommunications sectors and lowest in agriculture. Between 1998 and 2008 the level of productivity in the manufacturing sector shifted from below the business sector average to above the business sector average, largely due to the rapid productivity growth in high-technology manufactures. Within the manufacturing sector, labour productivity growth was highest in the textiles, office and computing machinery, and chemicals industries, with the latter two sectors also having by far the highest levels of productivity.

Table 3.1. Value added and productivity by sector¹

	Value added per worker (% growth) ²	Share in total value added ³ (%)		Share in total output ³ (%)		Value added per worker (EUR)	
	1998-2008	1998	2008	2000	2008	1998	2008
Business sector ⁴	3.8	74	79	82	85	16 476	23 974
Agriculture	2.4	4	2	3	2	4 866	6 166
Manufacturing	6.0	27	29	39	38	14 322	25 606
High and medium-high technology manufactures	6.9	10	13	15	17	16 432	32 093
Low technology manufactures	4.8	11	8	14	10	12 467	19 886
Construction	1.6	7	8	10	12	16 322	19 103
Utilities	4.0	3	3	3	3	33 687	49 708
Post and telecommunications	3.8	2	3	2	2	32 106	46 705
Transport and storage	3.1	5	5	6	6	17 416	23 731
Wholesale and retail trade	3.6	13	13	10	11	15 422	21 929

1. Using value added and gross output in constant prices, and total employment.

2. Annual rate.

3. Excluding real estate activities.

4. Non-agriculture business sector services excluding real estate activities.

Source: OECD (2010), *STAN Database for Structural Analysis*, December.

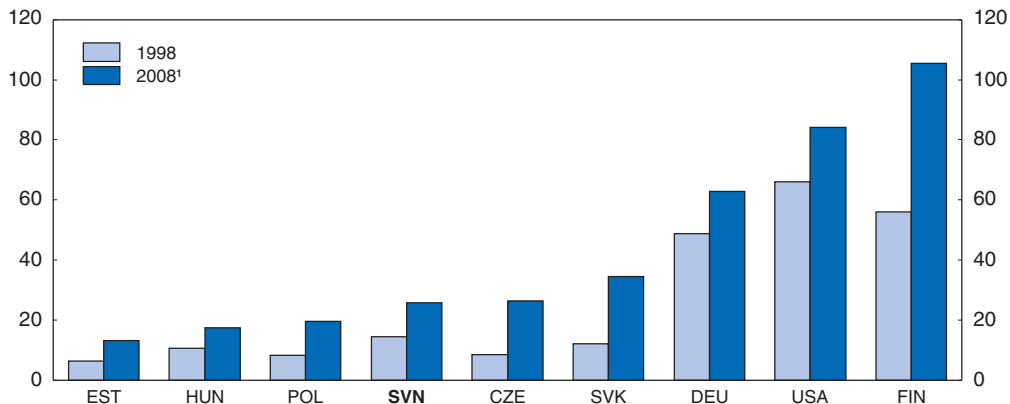
As an economy matures, productivity gains from efficiency improvements within a sector should make a relatively larger contribution to overall productivity growth than efficiency improvements from the reallocation of labour across sectors (OECD, 2009a). Analysis from the 2009 Survey showed that between 1997 and 2007 “within” sector efficiency improvements did indeed account for the most of Slovenia’s productivity growth, though the relative contribution was smaller than in most other transition economies. This smaller contribution can be partly explained by the more gradual pace of

privatisation and other reforms to the business environment in Slovenia. These issues are taken up in more depth later in the chapter.

Another way of gauging the scope for improving productivity growth in Slovenia is to compare its sectoral productivity growth and levels with other transition economies, as well as other more mature economies within the euro area. Productivity growth in the manufacturing sector was above the euro area average between 1998 and 2008, but below the rates achieved in the Czech and Slovak Republics (Figure 3.1). This pattern holds for both for low-technology manufacturing industries and medium and high technology manufacturing industries. Despite rapid productivity growth over that decade, the level of manufacturing productivity in 2008 was still only around one third of the euro area average, suggesting considerable room for further catch-up growth. The higher growth rates achieved by the Czech and Slovak Republics over the decade meant that by 2008, their level of productivity in the medium and high technology manufacturing industries had overtaken that of Slovenia, while the medium and high technology industries' share of economy-wide value added in 2008 was well below both the euro area average and the shares achieved by the Czech and Slovak Republics (Figure 3.2). Overall, there appears to be considerable scope for Slovenia to increase both the size and efficiency of its higher skill manufacturing sectors.


Figure 3.1. **Productivity levels in manufacturing**

Value added per worker in constant prices, thousand EUR



1. 2007 for the United States.

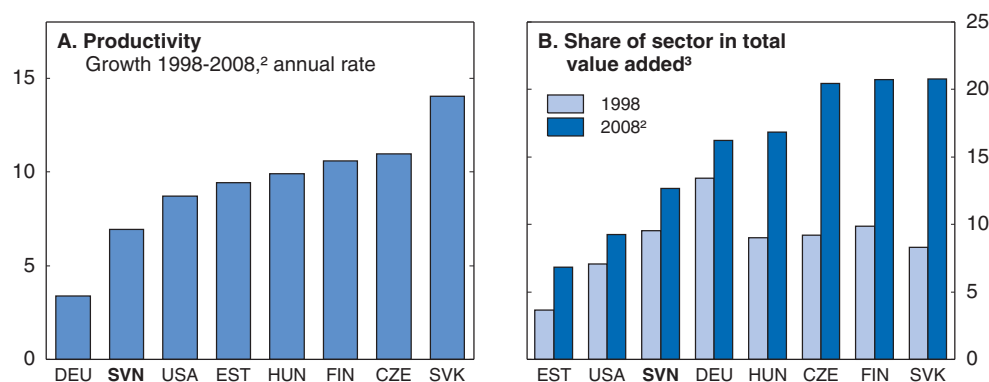
Source: OECD (2010), *STAN Database for Structural Analysis*, December.

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A similar pattern emerges from comparative productivity trends in other components of the business sector. In the *energy* sector, productivity growth between 1998 and 2008 was above the euro average and that of the Slovak Republic, but below that achieved in the Czech Republic (Figure 3.3). In 2008, the level of productivity in the *energy* sector was above that of the Slovak Republic, similar to the Czech Republic and well below that of the euro area and the United States. In the *telecommunications* sector, productivity growth has not been very impressive. Between 1998 and 2008 Slovenia managed growth rates below all the key comparison groups and by the end of 2008 there was still a very large productivity gap with the euro area and the United States.¹ In *retail trade* and *construction*, although there is a notable productivity gap between Slovenia and the euro area, the gap is somewhat smaller than in the energy and telecommunications sectors.

Figure 3.2. **Productivity in high-technology sectors**¹

Per cent



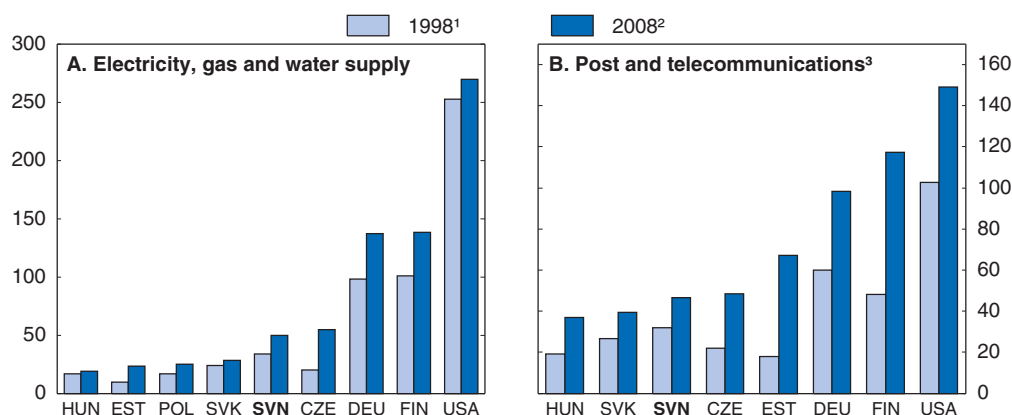
1. Value added in constant prices divided by total employment. Includes medium-high technology manufactures. No data is available for Poland.
2. 2007 instead of 2008 for Hungary and the United States.
3. Excluding real estate activities.

Source: OECD (2010), *STAN Database for Structural Analysis*, December.

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Figure 3.3. **Productivity levels in utilities and telecommunications**

Value added per worker in constant prices, thousand EUR



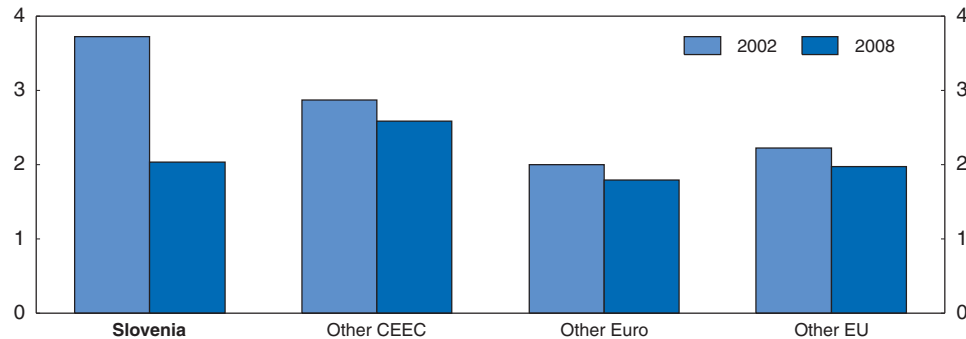
1. 2000 for Hungary in Panel B.
2. 2007 instead of 2008 for Hungary in Panel B and for the United States in both panels.
3. No data available for Poland for this sector.

Source: OECD (2010), *STAN Database for Structural Analysis*, December.

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Efficiency in Slovenia's *banking sector* appears low compared to other OECD European countries. Although simple indicators of cost efficiency, such as the ratio of operational expenses to total assets, improved significantly relative to other European countries during the 2000s (Figure 3.4), more sophisticated, multivariate methods for estimating efficiency suggest that there is still significant scope for improvement (Box 3.1). In particular, while there is evidence across a range of empirical approaches that the relative cost efficiency of Slovenian banks improved over the course of the decade, if anything, profit efficiency appears to have declined. Overall, the two large state-owned banks – Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) – appear to be among the least efficient banks in the country, particularly on a profit basis.

Figure 3.4. **Comparative cost efficiency in the Slovenian banking sector**
Operational costs in per cent of total assets



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Box 3.1. Analytical measures of banking sector efficiency*

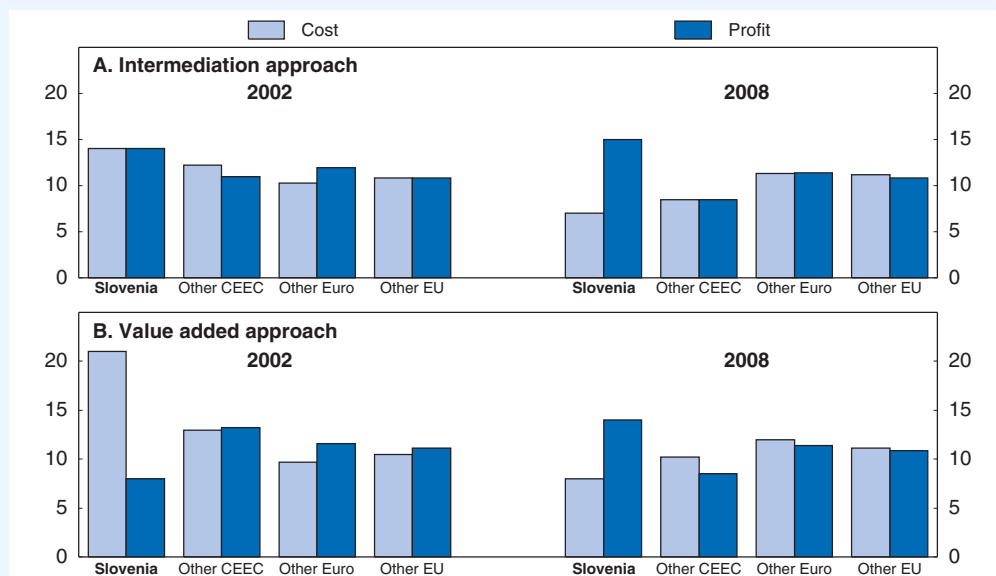
In the literature, there are two main statistical methods used to estimate the relative efficiency of banks – Data Envelope Analysis (DEA), and Stochastic Frontier Analysis (SFA). Both attempt to identify the efficiency frontier for a given sample of firms in the presence of multiple inputs and outputs (see Annex 3.A1 for methodological details). Individual banks are then assigned an efficiency score that measures their distance from the efficiency frontier. These techniques can be used to measure both the cost frontier – the minimum expenditure required to produce a given bundle of outputs, given the price of its inputs and the technology used – and the profit frontier – the maximum profit that can be generated given the price of inputs and outputs and the technology used. Under both methods, banks' measured efficiency can be sensitive to whether efficiency is measured on a profit or cost basis, the precise combination of inputs and outputs used, whether the technology is assumed to be constant or variable returns to scale and whether efficiency is assessed using the DEA or SFA method. Consequently, the relative efficiency of Slovenian banks is examined as each of these assumptions is varied.

According to these estimates, in 2008 Slovenian banks appeared to be relatively inefficient compared to those in other European countries. Across the full range of sensitivity checks, Slovenia's average efficiency ranking is 17th out of 21 countries (see Table 3.A1.4 in Annex 3.A1). Considering the DEA analysis in more detail, Slovenia's low relative efficiency is fairly insensitive to whether bank efficiency is measured using the intermediation approach – banks mediate between savers and borrowers – or the value added approach – banks produce deposits and loans from labour and capital (see Figure 3.A1.1 in Annex 3.A1). Slovenian banks also appear to be relatively cost and profit inefficient, though there is some weak evidence of a relative improvement in cost efficiency between 2002 and 2008. However, the average ranking of Slovenia's banks is more sensitive to different assumptions using the stochastic frontier analysis. In particular, there is evidence that the relative cost efficiency of Slovenian banks increased significantly between 2002 and 2008, while relative profit efficiency appeared to decline over the same period (Figure 3.5).

Box 3.1. Analytical measures of banking sector efficiency* (cont.)

Figure 3.5. Stochastic frontier analysis

Ranking among 21 countries

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Given the size and critical intermediation role played by Slovenia's two state-owned banks – Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) – it is also important to evaluate the relative efficiency of the two institutions. The SFA method suggests that, in 2008, NLB was among the more cost efficient banks in Slovenia but one of the least profit efficient. NKBM on the other hand was relatively inefficient on both a cost and profit basis.

Nevertheless, these results have to be interpreted with caution. Although Slovenia's relatively low efficiency ranking is fairly robust across our different methodological assumptions, the results for other countries often vary considerably across assumptions that are equally plausible. Also, efficiency can evolve over time. Previous studies, based on a sample period ending in the early 2000s, found that Slovenia was among the top performers in terms of cost efficiency (see a literature review of Banerjee, 2010). The analysis presented here makes use of data before the full effects of the financial crisis were evident. This matters because these methodological approaches are unable to determine which banks recorded high profit efficiency because of excess risk taking rather than genuinely efficient practices. Therefore, the conclusions could be further affected when 2009 and 2010 data become available thus allowing to better capture the impact of the financial crisis on implied efficiency. This suggests the need to continuously monitor banking sector efficiency in Slovenia.

* Dimitri Bellas provided research and drafting for this box.

What is holding back labour productivity growth in Slovenia?

In an accounting sense, countries can raise overall labour productivity through a combination of accumulating more physical and human capital (capital deepening), and using their existing endowments of labour, human capital and physical capital more

efficiently (total factor productivity). More fundamentally, capital deepening and total factor productivity growth are influenced by a range of policy-sensitive institutional factors. Education and training systems influence the accumulation of human capital and the capacity to innovate new technologies and processes. Tax systems influence incentives to innovate and invest in new capital. Financial systems influence the efficiency with which savings are transformed into productive capital. Labour market institutions influence the efficiency with which firms organise themselves. Trade policies and openness influence the incentives and ability of local firms and workers to absorb efficient processes from outside the country. Governments' sectoral policies and attitudes to overall business regulation shape the competitive environment that firms operate in and their incentives to restructure and innovate. And legal and political systems affect the willingness of entrepreneurs to take risks and invest, as well as the trust that underpins all market transactions.

Former socialist countries, such as Slovenia, have faced the additional challenge of having to create the political, legal and economic institutions that underpin trade and growth in a market economy almost from scratch. Most found, at the beginning of the transition process, that their levels of technological development were far below the OECD technological frontier. This meant that productivity growth was initially focused on catching up to other OECD countries through replicating best-practice processes rather than on innovations to push the frontier further out. This is important because the policies and institutions that encourage productivity growth depend on countries' stages of development (Acemoglu *et al.*, 2006; Berglof, 2006). For example, reforms to enhance competition through greater firm entry and openness to trade and foreign investment are more productivity enhancing for domestic incumbent firms and industries close enough to the frontier to adapt and innovate in the face of increased competition. Labour market and education institutions should focus on long-term investment in specific skills that are a long way from the frontier, whereas flexibility becomes relatively more important close to the frontier.

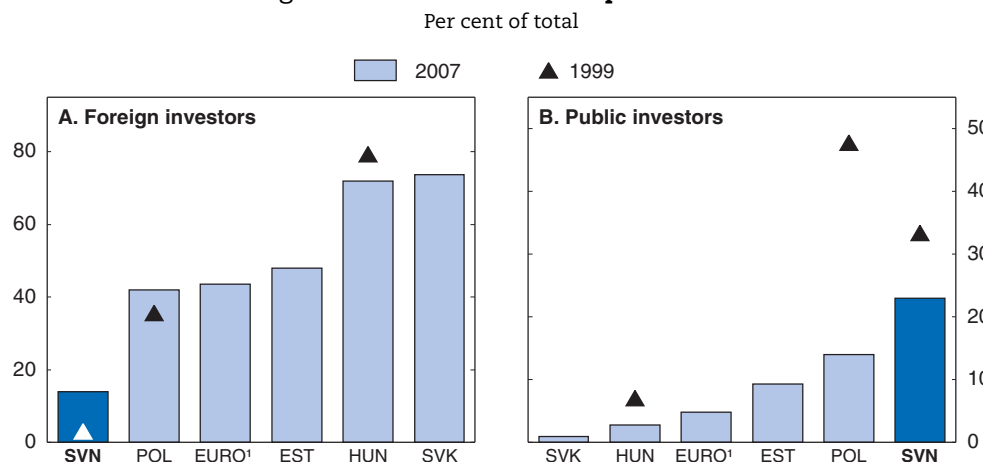
Given the once dominant role of the state in the economy, changes to the ownership status and structure of firms can have a particularly large impact on productivity performance in transition economies. Increased foreign ownership stakes through direct investment can enhance productivity growth in transition economies both directly, as foreign-owned firms bring new technology and management capabilities, and indirectly, through spillover effects on locally owned firms (Alfaro *et al.*, 2006; Bijsterbosch and Kolasa, 2009; Borensztein *et al.*, 1995; Hanousek *et al.*, 2010). Productivity growth has also tended to be higher in privatised firms than state-owned firms in transition economies as private firms have had greater incentives and flexibility to restructure, absorb new technologies and innovate (Bijsterbosch and Kolasa, 2009). The concentration of ownership within firms also matters. Evidence from a panel of Polish firms suggests that a high concentration of ownership is beneficial for productivity growth in low-technology sectors and firms a long way from the technology frontier. In contrast, in higher technology sectors and firms closer to the frontier, dispersed ownership is more conducive to managerial innovation (Hanousek *et al.*, 2010). This is because dispersed ownership appears to encourage managers to seek and be more receptive to new ideas.

Although there is a dearth of Slovenia-specific empirical studies on the factors constraining firm and sectoral level productivity growth, the evidence that does exist supports the importance of unit labour costs, human capital, innovation, technological development, and ownership structures (Damijan *et al.*, 2008). For example, high unit labour costs, inadequate science and engineering graduation rates and underdeveloped

innovation policies help to explain why Slovenia lags behind its Central and Eastern European country (CEEC) peers in the development of a high-technology manufacturing sector. The share of high-technology exports in total exports in 2008 was only around 5% in Slovenia, and more than 50% below the shares in the Czech and Slovak Republics. Although research and development (R&D) spending and innovation activity has picked up a bit in recent years, there is still a large gap to other OECD countries and there are insufficient links between R&D institutions and the business sector. The efficiency of the higher education sector also lags a long way behind best practice (see Chapter 2).


Slovenia has a somewhat unique pattern of firm ownership. Not only is the stock of foreign direct investment relative to GDP much lower than in most other transition economies, but the State's ownership share is much higher (Figure 3.6). These two phenomena are closely related. In other transition economies, widespread privatisation of former state-owned enterprises in the telecommunications, energy and transport sectors was an important driver of increased foreign investment. In Slovenia, the government has, for a variety of reasons, retained large direct ownership stakes in these sectors. Another unique aspect of Slovenia's enterprise ownership structure is the prominent role of the state-owned pension (KAD) and restitution (SOD) funds. The two funds have large controlling stakes in a number of large "strategic" enterprises across the business sector, which may have in turn partially inhibited the ability and incentive of foreign firms to acquire shares in these firms. The large direct and indirect asset holdings of the state make corporate governance a critical issue in Slovenia. Productivity growth in state-owned and controlled firms has been held back by the absence of high quality practices and institutions to effectively manage the state's ownership stakes and ensure that the state acts as a "good" shareholder. As part of its accession to the OECD, Slovenia has begun to reform the way the state's portfolio of assets is managed, with a view to rationalising its ownership stakes in the longer term. While the impact of high public ownership and governance policies on foreign investment and a broader restructuring in many sectors of the economy are investigated in the rest of the chapter, business environment issues were analysed in depth in the previous Survey (Box 3.2).

Figure 3.6. **Share ownership structure**



1. The euro area is an unweighted average of the latest data (2006 for Ireland and Italy) and excludes Luxembourg. No data is available for public investors for Finland and Ireland.

Source: FESE (2008), *Share Ownership Survey 2007*, Federation of European Securities Exchanges.

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Box 3.2. Progress on reforms to the business environment recommended in the 2009 Survey

The 2009 Slovenia Survey made a number of suggestions as to how the Slovenian government could improve the business environment through increasing competition, reducing barriers to entrepreneurship, and increasing the efficiency and effectiveness of innovation policies. Key recommendations included:

- Reducing state control in financial services and selected network industries through privatisation.
- Improving the management and governance of state companies.
- Improving public procurement practices to rule out collusion among tenders.
- Transforming the Competition Protection Office into an independent agency with budgetary autonomy.
- Easing employment rules and facilitating property registration.
- Widening the use of the credit registry to lower credit transaction costs.
- Increasing aggregate research and development (R&D) spending and in particular its private component.
- Having independent institutions benchmark innovation against international best practice.
- Reducing administrative dispersion by merging business innovation support programmes.
- Improving the efficiency of multi-purpose centres linking the research community, the business sector and the government.

The government has made progress in a number of these areas. Although there has been little privatisation activity in the past year, the government has taken concrete action to establish a new central ownership agency to manage the state's public asset portfolio and improve the corporate governance of state-owned enterprises. These reforms are examined in depth later in the chapter. As part of the programme of structural adjustments within the government's exit strategy, the government is in the process of establishing a new Public Procurement Agency to prepare new best-practice regulations, manage major public procurement projects and provide advice to contracting authorities and the government. Meanwhile, reforms to establish the Competition Protection Office as an independent agency with separate staffing and budget rules are underway. The government has also adopted a programme to reduce administrative burdens in the area of property registration and spatial planning. The key element of this programme is the development of an integrated electronic database of spatial data, real estate registrations, public infrastructure projects and administrative acts related to construction and planning. Work on the database should be completed by the end of 2013. There are also plans to simplify the procedures for obtaining building permits through streamlining environmental impact statements. Some tentative steps have been taken to boost innovation and R&D. In particular, a new Research and Innovation Strategy is currently being prepared. In addition, in July 2010, the Ministry of Economy put out a tender for the establishment of new Development Centres for Businesses to support the creation and development of new businesses.

Boosting foreign direct investment will help to raise efficiency

Foreign Direct Investment (FDI) is traditionally defined as the acquisition of at least 10% of the voting power (or equivalent) in a productive enterprise in a foreign country. Most often, firms engaging in FDI seek a controlling interest in the enterprise they establish or acquire. Reasons for firms to undertake FDI include:

- Breaking up the production chain to access lower unit labour costs for parts of the production process (vertical FDI). In transition economies, this type of FDI has been most common in manufacturing industries such as electronics and motor vehicle production.
- Improving market access in the presence of trade barriers and other frictions (horizontal FDI). In transition economies, this type of FDI has been most common in the telecommunications and utilities sectors as foreign firms have acquired former state owned enterprises (SOEs).
- Using a host country as a platform for exports to neighbouring countries (export platform FDI).

FDI can take place through either “greenfield” investments – building a new plant or establishing a new enterprise in a foreign country (usually associated with vertical FDI) – or cross-border acquisitions of existing enterprises. Within a country, these types of FDI can coexist, though “greenfield” investment may be more likely when there are large differences in factor costs between the home and host country. This also implies that as transition countries develop and their factor prices converge on those of the wealthier OECD countries, the share of “greenfield” investment is likely to fall (Nocke and Yeaple, 2004). The literature on foreign investment in Slovenia suggests that factor cost advantages have been the dominant reason for FDI in Slovenia, though access to regional markets has also been an important motivation (OECD, 2002). The evidence also suggests that investors’ focus is on the level of labour costs relative to the quality of labour, and investment tends to take place within multinational firms’ overall internationalisation strategy.

There are a number of channels through which FDI can be expected to boost the host countries’ productivity performance. For firms receiving FDI efficiency gains can come from technology transfers through supply chains, better management practices that enable firms to be reorganised and investors to react faster to changing economic circumstances, better integration with foreign markets, and more human capital formation (OECD, 2002). These channels help to explain why FDI tends to yield greater improvements in productivity than Foreign Portfolio Investment (FPI), which brings with it far less change in organisational structure and management. Efficiency gains may also accrue to firms in the same sector if new technologies spill over from recipient firms and FDI helps to boost competition within the sector, raising incentives to innovate and pushing inefficient firms out of the sector.

The balance of empirical evidence suggests that FDI has boosted productivity in transition economies. The shift in Central and Eastern European countries from unskilled labour intensive exports to more capital intensive exports was assisted by large inflows of FDI through greater integration with European production networks. And most former public utilities experienced significant increases in efficiency after they were acquired by foreign firms as corporate governance improved, excess labour was shed and firms were better able to exploit economies of scale (OECD, 2002). The productivity benefits of FDI appear to have been largest in those countries with the greatest capacity to absorb new technologies either through higher levels of human capital or better legal, regulatory and political institutions (Bijsterbosch and Kolasa, 2009). Overall, there is more evidence for FDI boosting productivity through the direct

effect on enterprises started up or acquired than through indirect positive spillover effects (Bijsterbosch and Kolasa, 2009; Damijan *et al.*, 2008; Hanousek *et al.*, 2010).

Evidence from Slovenia suggests that foreign owned companies perform better than domestically owned ones. Simoneti *et al.* (2002) analysed the growth of a large panel of non-financial firms during the mid-1990s and found that foreign owned enterprises experienced more rapid asset, sales, exports, value added and employment growth than domestic enterprises, even when controlling for the better growth potential for firms taken over by foreign enterprises. Although less than 5% of Slovenian firms had FDI in 2009, they accounted for 17.7% of total corporate assets, 15.2% of employees, 22.7% of operating profits and 38.6% of merchandise exports (Bank of Slovenia, 2010). In 1999, foreign owned manufacturing enterprises (FIEs) exported as much as 68.2% of their overall sales, with the motor vehicle and machinery and equipment industries achieving ratios above 75%.

FDI growth has been weak compared to other transition economies

The stock of inward foreign direct investment in Slovenia has grown significantly since Slovenia began the transition process. In 1994, the stock of inward FDI was just over EUR 1 billion and this had grown to almost EUR 11 billion in 2008, before declining to EUR 10.5 billion by the end of 2009 (Table 3.2). The majority of the stock of FDI has always been in the form of equity and reinvested earnings. Although the stock of FDI has grown each year since 1994, the pace of growth has fluctuated greatly over time, with both 2002 and 2007 being years of very rapid growth.

Table 3.2. Inward foreign direct investment

	Position (end-year stock)			Inflow ¹		
	Total		Equity and reinvested earnings	Total	From abroad	Reinvested earnings
	Value	% growth				
1994	1 081	..	788	..	..	-10
1995	1 376	27	939	..	..	-20
1996	1 612	17	1 028	..	..	-4
1997	2 000	24	1 413	..	..	26
1998	2 370	18	1 720	248	207	41
1999	2 675	13	1 905	322	298	24
2000	3 110	16	2 117	435	382	53
2001	2 940	-5	2 489	310	374	-64
2002	3 948	34	3 466	970	836	134
2003	5 047	28	4 439	938	742	196
2004	5 580	11	4 874	562	286	276
2005	6 134	10	5 607	661	410	251
2006	6 822	11	6 283	504	307	196
2007	9 765	43	6 776	1 165	1 082	84
2008	11 236	15	7 473	..	..	18
2009	10 500	-7	7 439	..	..	38

1. Total inflows are taken from a different source to the data in the rest of the table and are calculated as the sum of equity and other capital plus reinvested earnings. Inflows from abroad are calculated as the difference between total inflows and reinvested earnings.

Source: Bank of Slovenia and OECD Directorate for Financial and Enterprise Affairs.

Since 1994, sectoral FDI shares have changed significantly (Tables 3.3 and 3.4). In 1994 the largest share of the FDI stock was in the manufacturing sector, and in particular: wood, pulp, paper, printing and publishing; electrical equipment; and transport equipment. Large

shares were also recorded in the electricity and gas, wholesale and retail trade, and financial intermediation sectors. By 2009, manufacturing's share of FDI had fallen to 17.3%, and electricity and gas' share to less than 3%. By contrast, financial intermediation's share had increased to 45.2%. Notably, since 1994 the EU has come to dominate FDI. The large increase in the Austrian share is largely due to acquisitions in the banking sector.

Table 3.3. Foreign direct investment in Slovenia in selected activities

End-year stock

	1994		2000		2009		Change in % share 1994-2009
	Million EUR	%	Million EUR	%	Million EUR	%	
Total	1 081	100.0	3 110	100.0	10 500	100.0	..
Manufacturing ¹	451	41.7	1 265	40.7	1 817	17.3	-24.4
Electricity, gas, steam, air conditioning supply	242	22.4	19	0.6	262	2.5	-19.9
Water supply, sewerage and waste management	0	0.0	6	0.2	40	0.4	+0.4
Construction	2	0.1	5	0.2	105	1.0	+0.9
Wholesale and retail trade; repair of motor vehicles	161	14.9	471	15.2	1 653	15.7	+0.9
Transportation and storage	15	1.4	39	1.3	120	1.1	-0.2
Accommodation and food service activities	7	0.6	19	0.6	28	0.3	-0.4
Information and communication ²	3	0.2	52	1.7	243	2.3	+2.1
Financial and insurance activities	123	11.4	947	30.5	4 745	45.2	+33.8
Real estate activities	2	0.1	32	1.0	264	2.5	+2.4
Professional, scientific and technical activities	27	2.5	165	5.3	218	2.1	-0.4
Administrative, support and other service activities	11	1.0	8	0.3	45	0.4	-0.6
Other ³	50	4.6	90	2.9	1 006	9.6	+4.9

1. Excluding tobacco, fuel products and pharmaceuticals.

2. Excluding programming and broadcasting activities.

3. For the major part this covers activities having less than three companies with foreign direct investment in equity in certain years. It also includes real estate owned by non-residents from 2008.

Source: Bank of Slovenia (2010), *Direct Investment 2009*.

Table 3.4. Foreign direct investment in Slovenia by investing countries

End-year stock

	1994		2000		2009		Change in % share 1994-2009
	Million EUR	%	Million EUR	%	Million EUR	%	
Total	1 080.8	100.0	3 109.8	100.0	10 500.2	100.0	..
OECD	734.5	68.0	2 982.1	95.9	9 680.8	92.2	+24.2
European Union	670.5	62.0	2 732.6	87.9	8 737.0	83.2	+21.2
Austria	242.0	22.4	1 384.1	44.5	5 153.7	49.1	+26.7
Switzerland	51.3	4.7	129.6	4.2	958.4	9.1	+4.4
France	125.7	11.6	320.5	10.3	684.8	6.5	-5.1
Italy	111.1	10.3	193.9	6.2	586.1	5.6	-4.7
Germany	160.0	14.8	372.3	12.0	572.9	5.5	-9.3
Netherlands	9.0	0.8	96.4	3.1	551.9	5.3	+4.4
Belgium	4.0	0.4	7.6	0.2	337.1	3.2	+2.8
Croatia	334.1	30.9	54.6	1.8	325.4	3.1	-27.8
Luxembourg	0.2	0.0	35.2	1.1	239.2	2.3	+2.3
Other ¹	43.4	4.0	515.6	16.6	1 090.7	10.4	+6.4
<i>of which:</i>							
Czech Republic	0.1	0.0	112.8	3.6	77.6	0.7	+0.7
Hungary	-0.1	0.0	7.3	0.2	50.8	0.5	+0.5

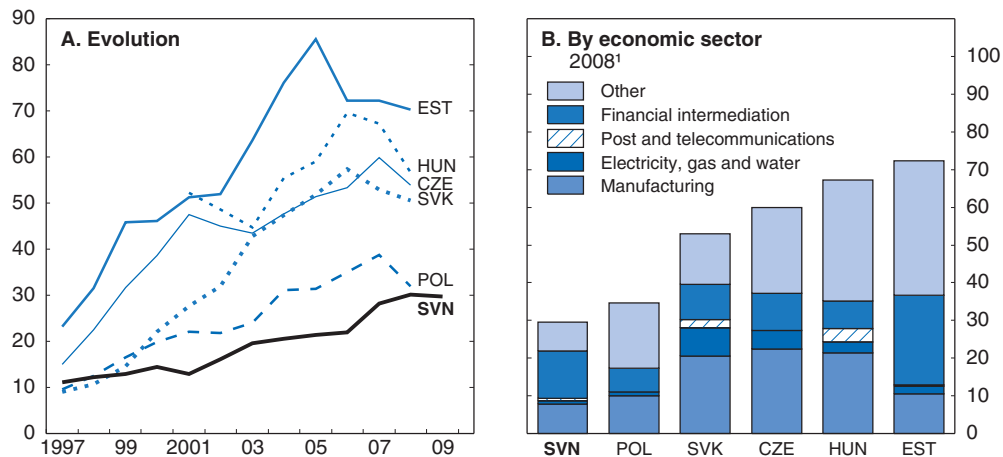
1. Data in 2009 includes real estate owned by non-residents.

Source: Bank of Slovenia (2010), *Direct Investment 2009*.

From a cross-country perspective, in the mid 1990s the stock of FDI as a ratio to GDP was similar to that of the other CEEC countries, at around 10% (Figure 3.7). However, over the next decade Slovenia's FDI stock grew much more slowly than the other CEEC countries, in part because mass privatisations in the network industries that were common across the region did not take place in Slovenia. Comparing Slovenia's sectoral FDI composition, financial intermediation is the only sector in which Slovenia's FDI share exceeds that of other CEEC countries. Slovenia's FDI share is much lower across all other sectors of the economy, particularly manufacturing and network industries such as energy and telecommunications.


Figure 3.7. **Foreign direct investment position**

Per cent of GDP



1. 2007 for Czech Republic, Estonia, Hungary and Slovak Republic.

Source: Eurostat (2010), "Economy and Finance", Eurostat Database, December and Bank of Slovenia (2010), *Direct Investment 2009*.

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Slovenia has improved policies that directly encourage FDI

On the face of it, Slovenia provides an encouraging environment for FDI. The 2001 Foreign Exchange Act granted freedom to both inward and outward FDI, there are now no restrictions on the legal status of foreign residents, and branches of foreign enterprises are considered as residents. However, in other respects the policy environment has not always been conducive to attracting foreign investors. For example, decisions made by governments at the beginning of the transition process helped to keep FDI low, even if that was not the intent. Although governments recognised that FDI could be an important bridge to developing an open, export-led economy within an integrated Europe, they never developed a consistent policy framework to bring it about. At the macro level, the monetary authorities resisted strong capital inflows to reduce upward pressures on the currency. Meanwhile, the privatisation process explicitly favoured internal buy-outs and was left incomplete, with the state directly and indirectly retaining large ownership shares in firms across the economy. Early in the decade, the government decided to be more active in encouraging greater FDI flows through:

- Opening the privatisation of state-owned assets to strategic and institutional investors.
- Adapting existing economic incentive schemes so that they are accessible to new foreign investors and comparable to those in competing countries.

- Providing a competitive regime of corporate taxation, tax relief for investment, depreciation allowances and loss carry-forward provisions.
- Establishing a state-owned company to manage industrial estates and assign state-owned companies with spatial potential the task of providing a competitive supply of land to domestic and foreign investors.
- Setting up an institution responsible for attracting FDI with a clear legal mandate, supervisory body, sufficient staff, and budgetary funding.

In 2001, the government set up the Slovenian Public Agency for Entrepreneurship and Foreign Investments (JAPTI), partially in response to criticisms that Slovenia was too passive about attracting FDI. JAPTI's mandate is to improve the attractiveness of Slovenia as a destination for FDI by providing a range of services to foreign enterprises considering new direct investment in Slovenia.²

There are now also a range of non-refundable financial incentives available to firms considering direct investment in Slovenia. Since 2000, the Inward Investment Cost-Sharing Grant Scheme has been in place to co-fund new direct investments in Slovenia that create jobs. The amount of co-financing available and the job-creation threshold for qualifying for the scheme depend on the characteristics of the firm and the nature of the investment project. For example, investment by new foreign investors, small firms, and projects in R&D, traded goods sectors and depressed regions receive more favourable treatment under the Scheme than other investment projects. Costs of non-commercial property, plant and equipment, employment creation, feasibility studies and advisory services (for small and medium-sized enterprises only) are all eligible for co-financing. Financial incentives are also available to firms for the purpose of hiring and retraining new staff who have been unemployed, new graduates or researchers taking up new positions in the company.

In addition to these direct financial incentives for FDI, Slovenia has put in place Free Economic Zones (FEZs) and Free Customs Zones (FCZs) in the port of Koper and the city of Maribor, recently extended to the end of 2013. Within FCZs, enterprises are not subject to either customs duties or other trade policy measures, until goods are released outside the zone. Eligible firms gain access to a range of benefits, including:

- Value added tax exemption for imports of equipment, production materials and services necessary for export production and other permitted activities.
- A reduction in the corporate tax rate from 20% in 2010 to 10%.
- A tax allowance of 50% for investments in tangible assets within the free custom zone.
- A reduction in the taxable base of 50% of the salaries of apprentices and the formerly long-term unemployed.

In January 2010, the government adopted fiscal measures designed to encourage businesses to locate and expand in the Pomurje Region, which was severely affected by the crisis. In October 2010, the government prepared a new draft law on Balanced Regional Development which extends the support instruments to three other regions. The measures put in place in the Pomurje Region until 2015 include:

- Grants for business environment improvement and capital investments.
- Tax incentives and refunds of social and health insurance contributions paid by employers.
- Possibility to reduce pre-tax profits by 70% of the capital expenditure for investment.

- Priority treatment of investment projects when bidding for financing from the National Development Fund and the EU Cohesion Fund.
- Provision of various forms of institutional support.

Companies registered in Slovenia are also eligible for facilities for export promotion and protection provided by the Slovenian Export Corporation, including financial services related to export insurance, financing and guarantee issuing. The Slovenian Export Corporation insures export credits against commercial as well as non-commercial risks and provides insurance against non-commercial risks in the case of Slovenian outward FDI. Financial support for special projects is available on a case-by-case basis.

But the enabling environment for FDI needs to be strengthened

Policies to directly encourage FDI are just one component of an overall strategy to attract foreign investment. Foreign investors are usually motivated by three principal factors: the expected profitability of individual projects; the ease with which subsidiary operations can be integrated with global strategies; and the overall quality of the enabling environment that affects the risks and expected payoff to firms considering direct foreign investment. Because countries cannot influence local market size and geography it is essential that they focus on improving the quality of the enabling environment. Key ingredients of a good enabling environment are (Blonigen, 2005; OECD, 2002):

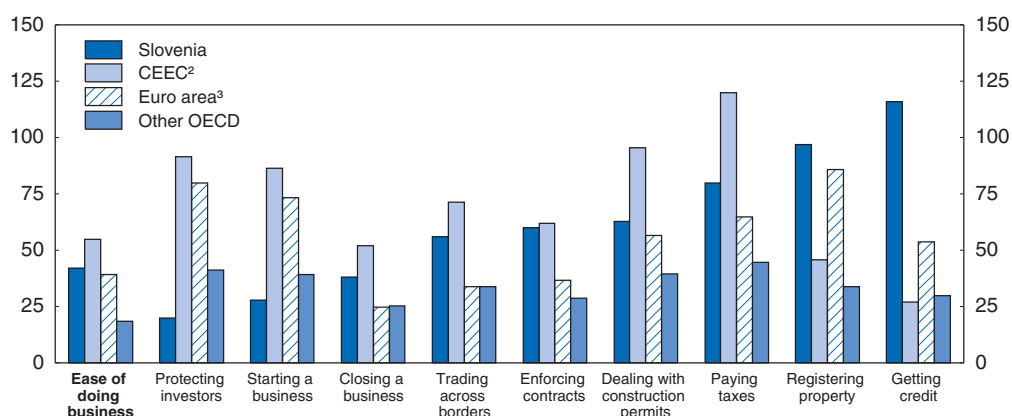
- Integration with foreign markets and openness to trade and investment.
- Sound macroeconomic policies and institutions to encourage strong growth while minimising volatility, maintain fiscal discipline and contain inflationary pressures.
- Transparent and efficient legal and political institutions to keep the business environment stable, reduce information costs and reduce resources devoted to rent seeking and corruption.
- An efficient and internationally competitive corporate tax regime.
- Flexible labour market institutions that encourage labour market participation, ensure that wages grow in line with productivity and keep hiring and firing costs low.
- High quality education institutions that ensure a supply of appropriately skilled workers.
- Deep and well functioning capital and intermediation markets.
- Low levels of red-tape to minimise the costs of setting up and doing business.
- Competition policy and sectoral regulatory and supervisory bodies that ensure there is a level playing field for foreign and domestic investors.
- Corporate governance policies that encourage sound management and accountability in private and state owned enterprises.
- Ownership policies that encourage the participation of private and foreign investors when anticipated efficiency gains from privatisation are large.

A survey of 140 foreign-owned firms undertaken by JAPTI (2009) found that the Slovenian business environment had features that both attracted and deterred foreign investment. On the positive side, a relatively stable political and macroeconomic environment, a geo-strategic position giving good access to European markets, a regulatory climate that is largely harmonised with the rest of the EU, efficient service provision and high-quality infrastructure have all encouraged foreign investors to locate in Slovenia. On the negative side, disincentives to doing business in Slovenia include: high taxes and

labour costs; difficulties dismissing employees or reorganising them within firms; a lack of properly qualified labour; inefficient judicial procedures, bankruptcy regulation and competition protection; difficulty acquiring land, business premises and construction permits; and the small size of the Slovenian market (Figure 3.8). In addition, privatisation at the beginning of the transition process favoured internal buy-outs and restructuring in privatised companies was slow and discouraged search for strategic foreign partners. Unfinished privatisation has also held back FDI in sectors such as energy, water, telecommunications, transport and banking. Similar constraints on FDI were identified in the OECD's *Investment Review of Slovenia* (OECD, 2002). Although there have been some improvements since then in terms of making it easier to establish firms, improving competition oversight, reducing corporate and personal tax rates, improving the functioning of tax administration and reducing foreign trade restrictions, overall progress on improving the enabling environment has been slow.

Figure 3.8. **World Bank Doing Business 2011 rankings**

Rank among 183 countries¹



1. Economies are ranked on their ease of doing business, with first place being the easiest. The higher the bar, the more difficult the business conditions. Zone aggregates are unweighted averages of rankings.
2. Central and Eastern European countries that are also OECD members: Czech Republic, Hungary, Poland and Slovak Republic.
3. Euro area countries prior to enlargement in 2007.

Source: World Bank and International Finance Corporation (2010), *Doing Business 2011: Making a Difference for Entrepreneurs*.

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The corporate tax regime does not appear to be a barrier to FDI

As corporate income taxes lower investment by reducing the net return on investment projects (OECD, 2007), FDI will, all else equal, be lower in countries with higher effective corporate tax rates. As already noted, however, a host of other framework conditions affect FDI and low taxes cannot substitute for weak framework conditions. Although it may be optimal for a small capital importing country facing a perfectly elastic supply of foreign capital to waive host country income tax on inbound FDI (with this tax fully shifted on to labour), if economic profit cannot be fully taxed, then some host country taxation by small capital importing countries can be efficient (Gordon and MacKie-Mason, 1994; OECD, 2007). Also, because host country framework conditions and market characteristics depend on past and current public spending on public goods it is important to collect tax on economic profit to finance spending on those public goods that attract FDI.

The effects of taxes on FDI can vary also substantially by type of taxes, measurement of FDI activity, and tax treatment in the host and parent countries. For example, multinationals usually face taxes in both the host and home countries, with countries having different ways of addressing this double taxation issue, which further complicates the expected effects of taxes on FDI (Gordon and Hines, 2002). In addition, when agglomeration economies are present, business concentration is reinforced, creating incentives to invest in large markets and export to small markets and introducing inertia in location decisions that can potentially be taxed without distorting investment. For these reasons, although most studies find a negative relationship between tax and FDI, estimates have a very wide range and depend on host country conditions and policies (Cummins and Hubbard, 1994; Desai *et al.*, 2005; Djankov *et al.*, 2008; OECD, 2007). There is some evidence that investment in physical capital is more tax sensitive than other components of FDI and that tax elasticities are larger for small open economies within the EU (Desai *et al.*, 2005; OECD, 2007). Consequently, the international evidence indicates that small open economies rely less on personal and corporate income taxes, and more on expenditure and trade taxes (Desai *et al.*, 2005). There is little evidence that dividend exemption and credits, or direct financial incentives such as investment co-financing have much impact on FDI (Blomstrom and Kokko, 2003).

Overall, tax does not appear to be a major constraint on foreign investment in Slovenia. Indicators of the efficiency of the Slovenian tax system are mixed compared with other CEEC and OECD countries. On the positive side, labour taxes and contributions are considerably lower than in the other CEEC economies.³ Although the administrative burden of the tax system is also lower, there is still a gap with more advanced OECD countries (Table 3.5). Comparing corporate tax regimes is complicated by the variety of alternative methods for calculating effective corporate tax rates and the fact that effective tax rates can differ according to the type of investment project and the way projects are financed. For example, according to the World Bank's *Doing Business Survey*, both the statutory and effective corporate tax rates are higher in Slovenia than the other CEEC economies, and around the average for all OECD economies. But, according to a recent project for the European Commission that uses an alternative methodology, Slovenia's effective corporate tax rate in 2009 was comparable to the other CEEC economies and lower than the euro area average (Table 3.6). Like most other OECD countries, the Slovenian corporate tax system favours debt financed projects over projects financed through retained earnings and equity. The system also appears to favour investment in machinery over other types of investments.

There are a few areas where reforms would be beneficial. Further reductions in the administrative burden of the tax system would be desirable through reducing the number of tax payments that need to be made and ensuring that the time that firms have to set aside to meet their tax requirements is reduced. Maintaining tax certainty and transparency is also important. Although the relative statutory and effective corporate tax rates in Slovenia are no longer particularly low, there appears to be little benefit in reducing the corporate tax burden much further in the current fiscal environment. This is reinforced by the fact that burden of very low corporate tax rates in some CEEC countries falls on labour, which in turn adversely affects labour supply incentives. However, if the trend to lower corporate taxation continues, Slovenia will also come under pressure to match other countries. In the meantime, given these competitive pressures the government should resist pressures to raise the corporate tax burden. Any increase in taxes to support further

Table 3.5. **Paying taxes**

2011

	Slovenia	Czech Republic	Hungary	Poland	Slovak Republic	Euro area ^{1,2}	Other OECD ¹
Payments (number per year) ³	22	12	14	29	31	12	12
Time (hours per year) ⁴	260	557	277	325	257	182	185
Total tax rate (% commercial profit) ⁵	35.4	48.8	53.3	42.3	48.7	47.9	38.7
Profit tax	14.8	7.4	16.7	17.7	7.0	14.7	19.3
Labour tax and contributions	18.2	38.4	34.4	22.1	39.6	30.7	15.9
Other taxes	2.4	3.0	2.2	2.5	2.1	2.5	3.4

1. Unweighted averages.
2. Euro area countries prior to enlargement in 2007.
3. Total number of taxes and contributions paid, the method of payment, the frequency of payment and the number of agencies involved.
4. Time taken to prepare, file and pay (or withhold) three major types of taxes and contributions: the corporate income tax, value added or sales tax and labour taxes, including payroll taxes and social contributions.
5. Sum of all the different taxes and mandatory contributions payable by the business after accounting for deductions and exemptions.

Source: World Bank and International Finance Corporation (2010), *Doing Business 2011* (database).

Table 3.6. **Effective average corporate tax rates¹**

Per cent

		Slovenia	CEEC ²	Euro area ³	Other EU	USA
Total	1998	20.9	28.6	31.5	27.7	..
	2009	19.1	17.8	25.2	18.8	37.4
Retained Earnings	1998	24.0	32.8	35.9	31.0	..
	2009	21.7	20.2	28.3	20.9	42.1
New Equity	1998	24.0	31.8	35.0	32.1	..
	2009	21.7	20.2	28.3	21.7	42.1
Debt	1998	15.3	21.2	23.6	21.3	..
	2009	14.4	13.4	19.5	14.5	28.6
Industrial Buildings	1998	18.8	28.7	31.6	28.6	..
	2009	18.5	19.0	26.1	20.0	38.0
Intangibles	1998	20.3	28.7	29.7	25.8	..
	2009	19.6	16.2	23.4	17.2	40.1
Machinery	1998	19.3	26.8	29.8	25.7	..
	2009	17.5	16.9	24.0	17.3	36.9
Financial Assets	1998	24.4	30.6	34.7	29.7	..
	2009	20.5	19.0	27.7	20.2	37.9
Inventories	1998	22.0	28.3	31.5	28.7	..
	2009	19.5	18.0	24.8	19.1	34.1
<i>Memorandum item</i>						
Statutory corporate tax rate ⁴	1998	..	31.6	37.8	..	39.4
	2009	21.0	19.5	27.1	..	39.1

1. Zone aggregates are unweighted averages.
2. Central and Eastern European countries that are also OECD members: Czech Republic, Hungary, Poland and Slovak Republic.
3. Euro area countries prior to enlargement in 2007.
4. Basic combined central and sub-central rate. Nominal rate for Slovenia.

Source: Devereux, M.P. et al. (2010), "Effective Tax Levels Using the Devereux/Griffith Methodology", Project for the EU Commission, TAXUD/2008/CC/099, *Intermediate Report*, Centre for European Economic Research (ZEW) and OECD (2010), *OECD Tax Database*, www.oecd.org/ctp/taxdatabase, July.

fiscal consolidation should be on less mobile factors of production and environmental taxes. In the longer run, consideration should also be given to reducing the large gap between corporate and marginal personal income tax rates, which creates incentives for business owners to avoid taxes by retaining earnings within their firm, and later selling shares in the firm, so that the earnings are taxed at capital gains rates rather than at personal rates. More could also be done to preserve the neutrality of the corporate tax system by reducing the bias against debt financing.⁴

The direct financial incentives available to foreign firms investing in Slovenia were benchmarked on policies put in place elsewhere in Europe and have helped to address concerns that the government's attitude to foreign investment was too passive. Economic and customs zones are also commonplace elsewhere in the region. Nevertheless, co-financing of investment projects and the special zones have an opportunity cost that make it necessary for the government to ensure that the costs of these policies are outweighed by their benefits. To date there has been little empirical analysis of the size of the welfare gains from these policies in Slovenia. However, the broader literature has found only weak evidence that direct financial incentives raise FDI, in part because they are often politically targeted. Welfare gains seem to be dependent on the existence of positive horizontal spillovers and are hence conditional on local firms having the ability and motivation to invest in absorbing foreign technologies and skills. This makes it vital to support learning and investment in local firms as well. In this light, the Slovenian government should undertake a review of current financial incentives, including a rigorous evaluation of their costs and benefits and how the net benefits can be increased. The government should also reconsider whether it is useful to offer larger subsidies to investment in export industries given the substantial productivity gaps that also exist in non-traded goods sectors. The performance of the special economic and customs zones should also be reviewed. One particular concern is the lack of activity in the Maribor customs zone. In the late 2000s, there were only a few firms operating within the zone, in contrast with the Koper customs zone. Although the government has pledged to keep the Maribor zone in place until at least 2011, they should quickly establish the reasons for the zone's poor performance and either put in place measures to improve the zone's performance or close it down.

Better labour market and education institutions would attract more foreign investors

Flexible and efficient labour market and educational institutions are a critical part of the enabling environment for FDI. Firms seeking to break up their supply chains through vertical FDI or increase their market access by acquiring inefficient domestic firms are less likely to target countries where it is difficult and costly to hire, fire and reorganise the workforce, where labour costs are too high, or where there is an insufficient supply of appropriately skilled workers. Investors weighing the merits of relocating or restructuring their businesses in another country need to be confident of achieving similar levels of productivity to production at home, but with lower labour costs. What matters to investment decisions is not so much the absolute cost of labour in different countries, but the cost of labour relative to its productivity. This implies that Slovenia, which has higher living standards and wages than other CEEC countries, can still be an attractive destination for FDI seeking factor advantage if labour productivity levels are sufficiently high to offset higher absolute labour costs, or if labour market institutions deliver superior flexibility to firms.

Unfortunately, survey and empirical evidence suggests that Slovenia's labour market and higher education institutions are a critical weakness in Slovenia's FDI environment. According to the World Bank's 2010 *Doing Business* Survey, Slovenia's "Employing Workers" ranking was the lowest of any OECD country, and lower than for any other indicator of the business environment considered in the Survey (World Bank, 2009). Slovenia's low ranking is consistent with its very high score on the OECD's Employment Protection Legislation (EPL) indicator, which reflects the high costs and difficulties associated with dismissing and altering the employment conditions of workers on regular contracts. In addition, while existing foreign investors in Slovenia appear to have achieved lower unit labour costs in their foreign subsidiaries than at home, overall unit labour costs in the manufacturing industry are high compared to other European countries (Table 3.7). For example, value added per employee is only a little lower in the Slovak Republic than in Slovenia, yet labour costs per employee are around 40% lower. This probably helps to explain why FDI flows into the Slovakian manufacturing sector, as well as overall sectoral growth have been so much higher than to Slovenia over the past decade. Slovenia's primary and secondary education system functions well, with students consistently ranked highly according to the Programme for International Student Assessment (PISA) tests. However, the higher education sector is inefficient, offers weak incentives for students to quickly complete their studies and acquire good qualifications in technical fields such as science and engineering, and doesn't do enough to encourage innovative partnerships with businesses (Chapter 2).

Table 3.7. **Value added and labour costs per employee**¹
Manufacturing sector, 2009

	Value added per employee (EUR)	Labour costs per employee (EUR)	Ratio of value added to labour costs
Slovenia	29 769	20 561	1.45
Austria	76 020	45 645	1.67
Czech Republic	23 936	12 612	1.90
Estonia	15 467	11 124	1.39
Germany	57 071	44 987	1.27
Hungary	20 345	10 033	2.03
Poland	17 561	7 875	2.23
Slovak Republic	25 737	13 134	1.96
EU15	59 491	41 217	1.44

1. Gross value added at basic prices and compensation of employees.

Source: Eurostat (2010), "Economy and Finance", *Eurostat Database*, December.

Progress on improving the flexibility of the Slovenian labour market and ensuring that labour costs grow in line with productivity has been slow.⁵ Some reductions to employment restrictions through the "mini-jobs" bill and other reforms have taken place. However, the reforms mainly increase flexibility in service sector industries where temporary work contracts are common, such as retail trade, hospitality and tourism, rather than sectors such as manufacturing and utilities, which are most in need of greater foreign investment. Moreover, too often wage setting appears divorced from economic considerations. Public sector wage growth has been rapid in recent years, which in turn has encouraged too many high-skilled workers into the public sector and put upward pressure on private sector wage growth. The recent decision by the government to raise the minimum wage by 23% will put further upward pressure on wages and undermine competitiveness (see Chapter 1).

Establishing a business has become easier but it is still too difficult to acquire and develop land

Other dimensions of the business environment that influence foreign investment are the administrative procedures that investors must complete before they can start their operations in a country. These include company registration, as well as the acquisition of land, business activity permits and building permits. In recent years there has been important progress in making it easier to establish businesses. The new e-VEM system of online company registration has reduced the time and cost of establishing limited liability companies and has helped to significantly improve Slovenia's ranking in the "Starting a Business" category of the World Bank's *Doing Business Survey* relative to other CEEC countries. A unified system of measuring administrative costs has been established, which has made it easier to undertake impact assessments of new regulations. And a Programme for the Reduction of Administrative Barriers is facilitating the simplification of administrative procedures and reducing the reporting burden for companies. However, despite this progress in reducing red tape, the foreign investors still face too many barriers to acquiring and developing land. According to the 2011 World Bank *Doing Business Survey*, Slovenia was ranked 97th out of 183 countries for the ease of registering property (Figure 3.8, above; World Bank [2010]). Supply constraints also reduce the availability of land and push up prices, though this problem has partially diminished as a result of the financial crisis. In line with efforts in other areas of administrative regulation, the government should take steps to significantly reduce the cost and complexity of land acquisition and development.

Productivity and FDI would be enhanced by rationalising public ownership and improving governance

Public ownership and control of enterprises operating in the market sector of the economy is widespread in Slovenia. State-owned enterprises (SOE) are classified according to whether they are directly (partially or wholly) owned by the state, owned indirectly through either the pension (KAD) or restitution fund (SOD), or a combination of the two. KAD manages Slovenia's civil servant pension schemes and also offers compulsory and supplementary pension schemes to the private sector. SOD was constituted to provide restitution to the previous owners of privatised firms and is expected to be wound down by 2016. The state had a direct share of more than 10% in 50 enterprises as of mid-2010 (Table 3.8). Of these, 19 were fully owned and controlled by the state, 15 majority controlled and in 16 the state had a minority controlling interest. Directly owned SOEs are most commonly found in network industries (energy, ports, telecommunications, post and rail), banking (including a majority stake in the two largest domestic banks) and insurance. Many of the firms in which the state indirectly holds a minority controlling interest operate in sectors of the economy, such as manufacturing, in which it is unusual amongst developed economies for the state to have a controlling interest. Five of the nine largest firms listed on the Slovenian stock exchange are effectively controlled by KAD and SOD (LJSE, 2009): Petrol – the largest supplier of oil and other energy products to the Slovenian market; KRKA – the country's largest pharmaceutical manufacturer; Zavarovalnica Triglav – an insurance company; SAVA – a holding company with interests in rubber manufacturing, tourism and real estate; and Gorenje – a manufacturer of domestic appliances. Of the other four largest listed firms, two – Telecom Slovenia and Nova Kreditna Banka Maribor – are directly controlled by the state, while ABANKA, another bank, is effectively controlled by other firms controlled by KAD and SOD.

Table 3.8. **State-owned enterprises**¹
Mid-2010

	Direct shareholding	Indirect shareholding ²	
	Number of firms	Number of firms	Value (million EUR) ³
Total	50	96	5 965
<i>of which: Listed companies</i>	0	17	305
Degree of state ownership			
Fully owned (100%)	19	20	2 193
Majority control (50 < 100%)	15	25	2 084
Minority control (10 < 50%)	16	51	1 666
Breakdown by investment type ⁴			
Strategic	5	9	2 548
Marketable	5	43	614
Non-marketable	31	35	2 609
Other	9	9	194
Breakdown by sector			
Mining and manufacturing	6	24	755
Energy	21	21	2 308
Financial services	4	8	1 457
Transport	6	9	396
Telecommunication	2	2	724
Tourism and trade	0	12	213
Other	11	20	112

1. Shareholdings of over 10%, excluding enterprises in liquidation or bankruptcy.

2. Republic of Slovenia, KAD (Kapitalska družba), SOD (Slovenska odškodninska družba) and PDP (Posebna družba za podjetniško svetovanje).

3. Estimated value using the book value of assets where a proper valuation is not possible.

4. Preliminary classification, marketable investments include PDP holdings.

Source: OECD calculations based on data provided by national authorities.

The ownership authority for directly owned SOEs resided within the line ministry with the responsibility for the industry in which the SOE operates until the establishment of the Agency for the Governance of Capital Investments, which is to exercise shareholder rights based on the *Corporate Governance of State Capital Investments Act*. Directly owned SOEs were classified by their legal forms, either as fully owned Public Enterprises under the *Public Utilities Act* or as limited liability companies under the *Companies' Act*. In the latter, most common case, the role of the competent ministry was set out in the *Public Finance Act* and included the supervision of operations and financing and the exercising of shareholder rights. SOEs over which the government had a “decisive influence” on management require the consent of the Minister for Finance, with the ministry coordinating the requests and the government’s ownership interests. The Ministry of Finance also had responsibility for overseeing KAD and SOD.

The high share of direct and indirect state ownership in the economy is largely the product of decisions taken at the beginning of Slovenia’s transition from a planned to a market economy (Domadenik and Prašnikar, 2004; OECD, 2002). Each citizen was granted an ownership certificate, according to his or her age, that could be exchanged for either shares in the company they were employed in, shares in the 100 or so companies that were offered to the public, or shares in authorised investment funds. Employee control of companies was favoured by the business culture that existed in the former Yugoslavia and this bias in favour of employee control was then retained by giving the managers and employees of firms considerable control over the way that privatisation took place

(Domadenik and Prašnikar, 2004; OECD, 2002). The Ownership Transformation Act (OTA) provided for the free transfer of a combined 40% of ordinary shares to KAD (10%), SOD (10%) and the Development Fund (20%). The Development Fund was then authorised to auction these shares to investment funds, which paid for them with ownership certificates bought from citizens. Under the OTA it was possible for firms to distribute up to another 20% of shares to employees, also in exchange for ownership certificates. Firms then had the option of undertaking an internal buyout of shares, limited to 40% of the firm's social capital, or selling shares commercially.

A virtue of the Slovenian privatisation process is that by progressing slowly and in a manner compatible with the existing business culture, political support for privatisation, and transition more generally, was easier to maintain (Domadenik and Prašnikar, 2004). This in turn enhanced political and economic stability. However, these benefits came with costs. High and widely dispersed internal ownership and ineffective external ownership in many companies provided management with insufficient incentives to restructure enterprises (OECD, 2002; OECD, 2011). Following the first phase of privatisation, internal owners were on average left with 44% of total ownership within privatised firms and even larger shares in internally privatised firms. Internal owners were concerned with keeping their jobs, rather than with maximising firms' profitability, and external owners had insufficient power and incentives to change and monitor management practices. For example, Privatisation Investment Funds (PIFs), which received 20% of the shares in newly privatised firms, have been unable to achieve their intended role of offsetting the influence of insiders and helping to ensure proper monitoring of management performance (OECD, 2011). Given these problems, the success of the privatisation process was dependent on ownership becoming more consolidated over time as transitional owners exited firms and the share of strategic investors increased. Although ownership concentration has increased over the past decade, this secondary privatisation process has been slow and uneven and strategic foreign investors have had difficulty acquiring controlling shares in companies and internal owners have retained considerable influence in many firms.

Another problem is that foreign investors were more or less excluded from the first phase of privatisation (Domadenik and Prašnikar, 2004; OECD, 2002). Overall, strategic investors acquired ownership stakes of less than 3% in privatised firms, and even this low share went largely to domestic investors. Low foreign participation in the privatisation process, which was unique amongst transition economies, flowed naturally from the emphasis on internal buyouts and allocating most of the external shares to state and quasi-state funds. This meant that privatised firms were unable to benefit from the superior technologies and management skills of foreign investors. Empirical studies have generally found that post-privatisation ownership consolidation did little to improve efficiency or financial performance during the 1990s, with survey evidence suggesting this was in part due to insufficient involvement of strategic foreign investors (OECD, 2002). Although FDI has increased notably since the first phase of privatisation was completed, the FDI share remains low by CEEC standards.

Instead of private domestic and foreign investors playing their optimal role as strategic investors, this role has instead been filled by the two large state-owned funds – KAD and SOD (OECD, 2002; OECD, 2011). This has allowed the state to influence large sections of Slovenia's market sector. Both funds were allocated 10% of the shares of firms in the first phase of the privatisation process. When the two funds were first set up, the intention was that they primarily be portfolio investors in privatised firms. However, in

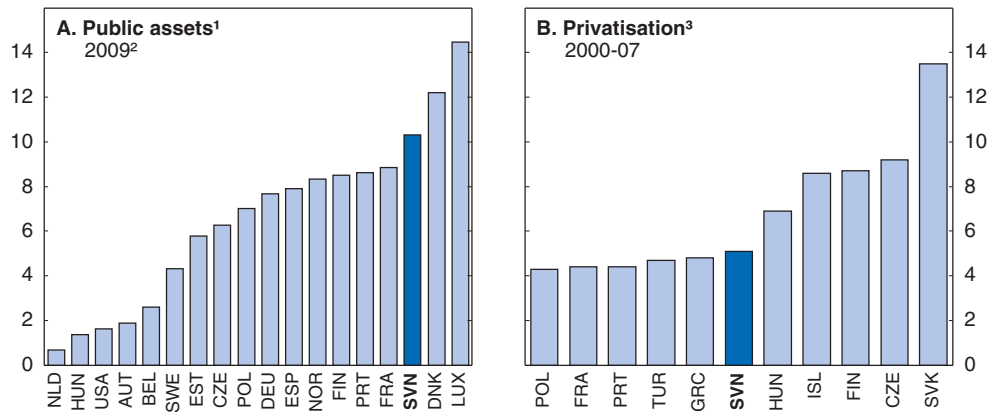
practice the funds, and in particular KAD, have concentrated their ownership holdings in large, strategically important firms (OECD, 2011). For example, KAD reduced its asset portfolio from over 1 200 firms at the completion of the first phase of privatisation, to around 80 firms in 2009. Ownership of the two funds has made it possible for successive governments to influence the boards and management of privatised firms, control ownership changes and prevent foreign firms from gaining control over domestic firms and sectors deemed strategic by the government (OECD, 2011). There are concerns that board appointments have often been politicised and some transactions in state assets appear to have taken place below market prices (OECD, 2009b; OECD, 2011). Although, legally, the two funds are independent of government and have their own supervisory boards, in practice the actions of the companies appear to be coordinated, with governments viewing the funds' holdings as part of an overall government portfolio (OECD, 2011). The government's true stake in and control over companies is also opaque. Companies in which the government and the two state funds hold controlling positions also invest in other listed and non-listed companies. It is therefore difficult to get an accurate picture of the extent of government ownership and control from public sources. Although the Ministry of Finance is supposed to keep a record of the government's equity holdings, it does not collect comprehensive data on its beneficial ownership through the state owned funds and subsidiaries (OECD, 2011). This significantly reduces the transparency of the business environment for potential foreign investors.

The lack of transparency and accountability is also reflected in the legal, judicial and regulatory systems. For example, the rights of minority shareholders are protected by rules such as the requirement of a qualified majority for large changes to the capital structure and constitution of companies, and the right to ask for independent auditors to examine matters such as the financial accounts. In practice, however, the rights of minority shareholder are constrained by high thresholds for voting shares and the courts are inexperienced in dealing with commercial litigation. Consequently, market participants often consider the process of enforcing contracts and seeking redress both costly and too time consuming (OECD, 2011). The Securities Market Agency has also lacked the operational and financial independence to effectively regulate the market for corporate control. This has in turn sometimes led to questionable takeover practices, including acquiring firms holding shares in another company name (this is commonly known as share parking) (OECD, 2011).

SOEs remain dominant in the electricity, telecommunications, banking, rail, port and postal sectors. State ownership is not confined to market segments over which single firms have a natural monopoly (such as fixed-line telecommunications networks) but extends to market segments where SOEs compete against private companies. The flip side of the dominance of SOEs is that privatisation activity has been much lower than other transition economies (Figure 3.9). Between 2000 and 2007, the proceeds from privatisation in Slovenia amounted to just under 5% of GDP. This compares to 7% in Hungary (which also had a much larger privatisation programme during the 1990s), 9% in the Czech Republic and almost 14% in the Slovak Republic. Many SOEs in Slovenia have low productivity and profitability, in particular in the banking sector (Box 3.1) and utilities industries where the state sector dominates. Extensive state ownership has also held back the development of an effective corporate governance regime. These weaknesses all hold back economic performance in a country where SOEs represent a sixth of all value added in the economy.


Figure 3.9. **Public ownership and privatisation in Slovenia compared to other OECD countries**

Per cent of GDP



1. As represented by "other equity" from the consolidated financial accounts of the general government sector. This covers financial equity assets and excludes quoted and unquoted shares in companies and mutual fund shares.
2. 2007 for Luxembourg.
3. In per cent of 2006 GDP. For most of the countries shown (the top-10 OECD countries) the data include "indirect privatisation", i.e. the disposal of incorporated assets by wholly or partly state-owned enterprises.

Source: OECD (2010), *OECD National Accounts Statistics* (database), December and OECD (2009), "Privatisation in the 21st Century: Recent Experiences of OECD Countries", OECD Working Group on Privatisation and Corporate Governance of State Owned Assets.

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The government has launched important reforms to improve the management of public assets

The Slovenian government has recognised the weaknesses in the management of state-owned assets and the corporate governance framework, and launched a comprehensive reform programme as part of its accession to the OECD. In May 2009 the government formally adopted an Action Plan for Corporate Governance Reform in Slovenia. Key elements of the Plan included:

- A review of the legislative provisions protecting minority shareholder rights.
- An increase in the capacity of the judicial and regulatory authorities to monitor and enforce compliance with corporate laws.
- The establishment of a separate central ownership agency to coordinate all government ownership actions.
- An intention to better define the relationship between the government, KAD and SOD, and to restructure the funds as independent portfolio investors.

Subsequently, legislation establishing the new central ownership agency was passed in May 2010 and the agency was established in September 2010. Under the new law, the Agency for the Governance of Capital Investments of the Republic of Slovenia will:

- Control all the direct holdings of government.
- Exercise all of the ownership rights pertaining to all direct and indirect shareholdings, including board nominations.
- Gather centralised information on government holdings.

- Measure and report performance.
- Develop and enforce a code of corporate governance that will apply to SOEs.

The Agency will operate independently of existing ministries, and will have a supervisory and management board with members appointed by a qualified majority of Parliament on the recommendation of the government. By the end of 2010 the Agency was required to adopt a code of corporate governance for SOEs, and define and allocate public financial assets into sub-groups (marketable, non-marketable, strategic, public interest) that will help to determine which assets should remain in public hands.

An act governing the restructuring of KAD and SOD and their relationship to the government was adopted in September 2010. As stipulated by the Act, KAD is in the process of being split into a pension fund manager and an insurance company, with the Agency then exercising the shareholding rights. Although the funds will not be able to acquire shares with voting rights representing more than 5% of all voting rights, controlling shares of the funds are to remain on the funds' balance sheets, with the central agency responsible for managing the strategic holdings on behalf of the funds.⁶ This may make it more difficult for the government to reduce its overall strategic holdings; the central agency will manage the assets on behalf of the state, but the KAD and SOD claimants will remain the beneficial owners.

The government has also initiated reforms to other aspects of the corporate governance framework. To contribute to improved governance of SOEs the government has announced that an independent expert group will be asked to develop a list of "approved" directors from which government nominees will be drawn. For larger companies, the group will make specific non-binding recommendations to the relevant minister, with the process of nomination coordinated by the central ownership agency. A new process for making appointments to the boards of KAD and SOD will be determined at the same time as the relationship between the government and the funds is clarified. To improve the transparency of takeover activity, the government has taken measures to reduce share parking and the Securities Market Agency has been given the power to withhold voting rights in the event of breaches of the legislation.

To improve shareholder rights the government has announced that all proposals to be heard at companies' annual general meetings must be received by all shareholders in advance. Also, the appointment of proxies will be streamlined and the Code of Corporate Governance for SOEs should be finalised in early 2011; this is expected to improve the treatment of non-state shareholders in SOEs and protect minority shareholders in particular. The government has also proposed a survey to examine the performance of the Companies Act, to be completed by 2012. The survey will focus on how to better enforce the rights of minority shareholders, creditors and other stakeholders and improving commercial litigation procedures. Another aspect of the government's overhaul of corporate governance is a review of the regulatory and supervisory framework for financial institutions to determine if it makes sense to amalgamate the separate functional regulators into a single "super-regulator". Although there are likely to be benefits from a more harmonised approach to financial market regulation and supervision, amalgamation is probably not a near-term priority.

The key to achieving the efficiency gains will be in how reforms are implemented

The steps taken in 2009 and 2010 to reform the governance of the state's capital investment portfolio will help to improve the quality and transparency of Slovenia's business environment. The government should be congratulated on starting down this reform path in a difficult economic and political environment. However, the magnitude of the efficiency gains from these reforms will ultimately depend on how they are implemented.

The central ownership agency must be strong, well resourced and accountable

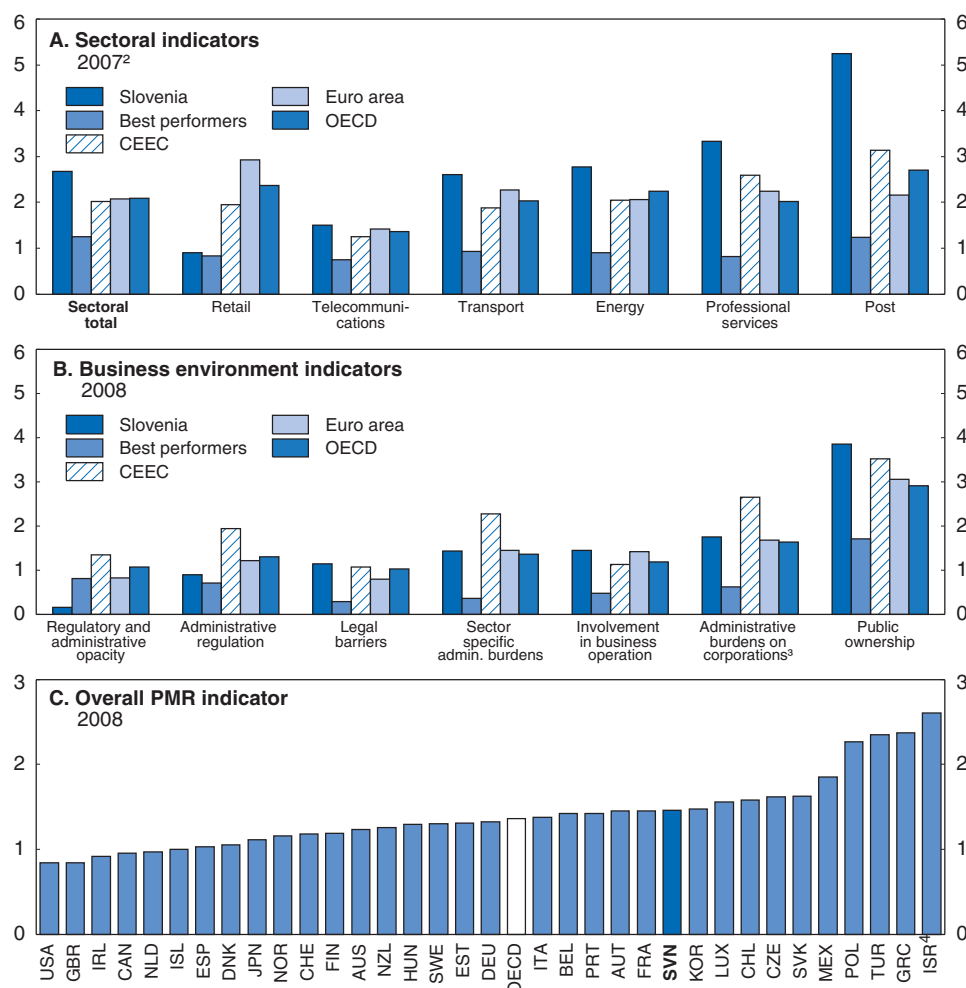
Central ownership agencies have been commonplace in European countries with large public asset portfolios. In the past decade, Austria, Belgium, Finland, France, Hungary, Portugal and Spain have all had central agencies in place, though some have been discontinued as privatisation programmes have come to an end (OECD, 2009b). To carry out its ownership functions on behalf of the state properly, such an agency must be competent, well resourced and subject to high standards of accountability and transparency through an effective internal corporate governance regime. To ensure independence, the appointment process for the Agency's board and management must be transparent and based on merit. Leaders of the Agency cannot be seen to be linked with vested interests within the country. The process for appointing staff should also be based on merit. The Agency should also look into recruiting experts on managing public assets and privatisation from outside the country, as this would help make up for the shortfall in domestic expertise and reinforce independence. An effective internal corporate governance regime is important to ensure that the Agency is well run, bolster public confidence, and set an example of what the Agency will expect from other SOEs. The success of the new Agency will also depend on the support of political actors and institutions. If it is seen to fall short of expectations in any of these areas, its ability to ensure better quality of management and allocation of public capital assets will be compromised. It should be clear by the end of 2010 whether the Agency has been constituted according to the appropriate principles.

The criteria for retaining public assets must be rigorous and transparent

Perhaps the most important task for the new Agency will be to develop a strategy for the future management of public assets that, in particular, defines the ownership objectives of government. This will then enable it to allocate existing public assets into categories that will help determine which assets should be retained in public hands and which should be privatised or wound down. It is critical that the Agency provides a framework of what should be considered a strategic asset and provide a rigorous rationale for why such assets should be owned by the state. Currently there is a widespread perception that "strategic" is a catch-all term for any asset that the government wants to keep out of private hands, or companies that the government wants to retain the freedom to influence for political ends. Instead, the central Agency must outline what the public interest in holding a given asset is, and why those interests could not be fulfilled if the asset were in private hands.⁷


Accelerating the privatisation process, if done in the right way, would significantly boost productivity in a number of key infrastructure sectors. Slovenia's score on the OECD's product market regulation (PMR) indicator is worse than most of its peers in CEEC and other OECD countries, largely because Slovenia performs poorly on the public

Figure 3.10. **Product market regulation**
Scale of indicators 0-6, from least to most restrictive¹



1. All aggregates are unweighted averages. Best performers are the five countries with the lowest scores (excluding those scoring under 0.2). CEEC covers Central and East European countries that are also OECD members: Czech Republic, Hungary, Poland and Slovak Republic. The euro area includes member countries prior to enlargement in 2007.
2. 2008 for professional services and retail.
3. And sole proprietor start-ups.
4. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD (2009), *International Regulation Database*, www.oecd.org/eco/pmr, September.

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ownership component of the indicator (Figure 3.10). Reviews of the enormous literature on privatisation in transition and other economies have generally found that privatisation has boosted efficiency and profitability in privatised firms, and that reforms to liberalise markets in network industries have been more effective when coupled with privatisation (Djankov and Murrell, 2002; Shirley and Walsh, 2000). Private firms tend to undertake much more internal restructuring and are able to take on more financial risk than public enterprises. The method of privatisation also matters; enterprise

restructuring and efficiency gains are greater when firms are privatised to outsiders than when they are privatised to insiders, and the presence of private investment funds and foreigners yields much larger gains than diffuse individual ownership (Djankov and Murrell, 2002; Shirley and Walsh, 2000). Although privatisation is generally associated with a lowering of employment, the impact is often attenuated by the boost in sales associated with better overall performance (Djankov and Murrell, 2002; Shirley and Walsh, 2000). Short-term benefits of privatisation may be smaller for well-run SOEs that are already corporatised, though full and successful corporatisation of SOEs is often not feasible (OECD, 2009b). For example, incentivising SOE management and employees can be very difficult. The theoretical literature is more ambiguous about the economic benefits of privatisation in markets subject to natural monopolies. SOEs may be able to correct market failures in monopolistic markets and governments may have more difficulty preventing natural monopolies from exploiting their market power (Djankov and Murrell, 2002; Shirley and Walsh, 2000). However, empirical studies have found that private firms often have advantages in these markets as well due to their greater efficiency and the fact that governments have proven better regulators and supervisors of privatised monopolies than state-owned monopolies (Djankov and Murrell, 2002; Shirley and Walsh, 2000). This is consistent with the argument that government ownership politicises resource allocation.

Other benefits are also likely to flow from rationalising the role of the state in the Slovenian economy. A legacy of extensive public sector ownership and dominant state-owned strategic investors is that Slovenia's legal and regulatory architecture of governance and the cultural norms of operating private capital markets are not well developed (OECD, 2011). Countries that have launched major privatisation programmes tend to have deeper and more liquid equity markets and privatisation is usually a spur to improving corporate governance, securities market regulation and information disclosure rules (OECD, 2009b). In turn, improved corporate governance facilitates a business environment that is more competitive and more conducive to FDI, and that improves management incentives for efficiency enhancing enterprise restructuring.

It is important to avoid pre-judging the allocation of existing public assets until the new Agency begins setting out its framework for decisions and plans for individual assets later in 2010. However, as a rule of thumb there should be a bias against owning assets that are in direct competition with private assets or in markets where there is potential for significant competition. In competitive markets, public ownership can give the impression that the playing field is not even, which can deter private investment. In time, both KAD and SOD should be reduced to portfolio investors. There also needs to be regular rigorous, quantitative cost-benefit analyses of the merits of retaining the state's existing equity stake for all SOEs, as has been put in place in transition countries such as the Czech Republic and Hungary. In key infrastructure sectors, and especially natural monopolies, there should at least be an attempt to examine whether universal service obligations could be written into private contracts and effectively enforced. Given the size of the potential privatisations in Slovenia, sequencing will be very important. The Agency will need to draft a list of assets that would benefit most from privatisation and identify those assets for which the process is most feasible.

Although a detailed discussion of the privatisation process is beyond the scope of this chapter, the experience of other OECD offers a pathway for maximising the benefits of

reform (OECD, 2009b). In most cases considerable preparation will need to take place before privatisation. For example, structural separation in sectors such as telecommunications should occur before privatisation to ensure that governments are not left trying to regulate unstable market structures and deal with purchase decisions that would not have been made under different market structures. Pre-privatisation restructuring is often unproductive because new investors are usually better placed to undertake necessary managerial changes. However, governments can be in a good position to restructure the firm's employment and capital structure prior to privatisation. To get the best value for taxpayers, governments should undertake pre-privatisation valuations and make sure that share offerings are not underpriced and not targeted at particular investor groups for political reasons. Bidding for shares should be competitive and if the government does want to target preferred investors there should be a pre-qualification followed by competitive bidding and minority shareholders should be given full information about large investors' obligations (such as community service obligations). Governments should not retain "golden shares" (giving them veto power over certain control changes) or insert other control restrictions into the corporate charters of privatised firms. Privatisation should be subject to independent oversight and high levels of transparency and accountability should be ensured, with regular disclosure to Parliament. It is critical that legal and regulatory frameworks, including effective anti-trust enforcement and corporate governance, are put in place and that regulators are well resourced so that there is a level playing field in markets where SOEs compete.

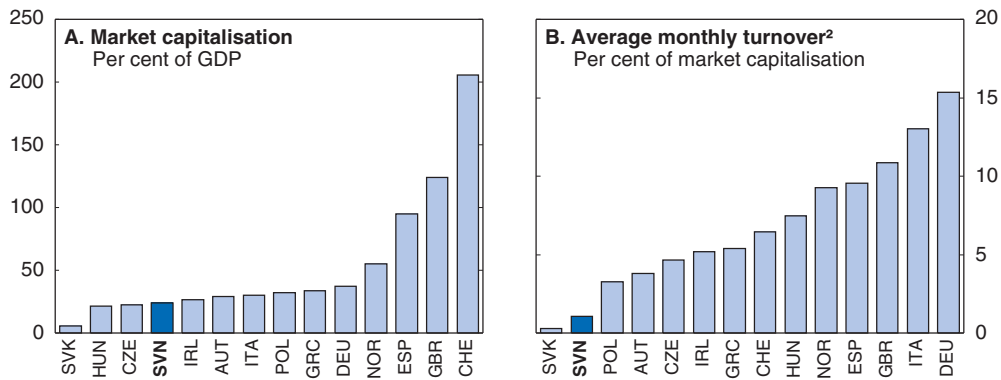
For assets that remain in public hands, governments must become more effective owners by enhancing their ability to make objective and commercial decisions as a shareholder and having a coherent and transparent policy towards SOEs (OECD, 2004 and 2005). The government ownership Agency should closely follow the OECD's SOE Corporate Governance Guidelines when it sets out its own corporate governance framework for Slovenian SOEs. Most importantly, the state should not be involved in the day to day management of SOEs and boards should be composed of experts who can exercise independent and objective judgement. Rules should be relaxed to allow more professional board members and board members should not be political appointees. Privatised companies also need a state of the art board nomination process, with mechanisms to ensure that minority shareholders gain board representation.

Accelerating privatisation would deepen capital markets and enhance spillover benefits from FDI

Slovenia is characterised by a shallow and relatively illiquid capital market. In December 2009, total equity capitalisation was EUR 8.5 billion, representing just 24% of GDP, while average monthly turnover was less than 1% of total market capitalisation (Figure 3.11). Both ratios are low in comparison to other EU countries. The corporate bond market is also underdeveloped, with the stock of corporate debt a tiny fraction of the stock of business credit outstanding. Deepening capital markets can yield a range of economic benefits. For example, empirical evidence suggests that financially developed countries grow more rapidly and benefit from a larger impact on economic growth from increases in the share of FDI or the relative productivity of foreign owned enterprises (Goldberg, 2004). One reason for this effect is that deeper capital markets can enhance the gains from FDI spillovers to smaller, local firms. Equity finance helps to diversify firms' funding away from banks, is more compatible with investments in venture capital and start-ups with low


initial cash flows and helps to channel savings into domestic investments. These benefits are vital for local firms trying to compete with foreign owned firms that often have access to a range of low-cost finance options in their home and other markets.

Figure 3.11. **Share market capitalisation and turnover**
2009¹



1. December 2009 for market capitalisation.
2. Value of equity trading in the year to December 2009.

Source: FESE (2010), FESE Statistics Database, Federation of European Securities Exchanges.

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Improving the depth and liquidity of capital markets in Slovenia will be difficult. Financial intermediaries have established a dominant position in the funding market and an “equity” culture is not something that can emerge overnight. The original privatisation process led to a large proportion of listed shares being held by either small public shareholders or the two large state investment funds, both of which trade their shares infrequently. Moreover, the majority of the big SOEs are not currently listed on the stock exchange. Nevertheless, a number of reforms would help to boost financial development. Relaxation of rules that require minimum returns for pension funds would increase investment flexibility (OECD, 2011). Encouraging greater competition in brokerage services would increase access to brokers and reduce the current high fees, which would in turn facilitate more participation in the market by retail investors. Listing companies in which the state has a large share would facilitate market oversight, improve the transparency of trading of the non-state owned share and increase the range of available investable securities (OECD, 2011). For example, only one of Slovenia’s large financial institutions is listed. Accelerating the privatisation process would also enhance the depth and liquidity of the equity market, especially if done through an Initial Public Offering (IPO) rather than a private sale.

Box 3.3. Recommendations on foreign investment and governance

Enhancing Slovenia's attractiveness as a destination for foreign direct investment

- Lower the administrative burden of the tax system through reductions in the regularity of tax payments and the complexity of tax compliance.
- Maintain the low effective corporate tax burden and work toward greater European corporate tax coordination.
- Ensure that the tax system does not unduly discriminate between different sources of investment financing.
- Review existing direct financial incentives and the performance of the special economic and customs zones to make sure that such support is cost effective and is not biased against investment in non-traded goods and services sectors.
- Reduce the tightness of employment protection legislation for the regular contracts that are prevalent in the infrastructure and manufacturing sectors.
- Streamline processes for accessing business premises, land and building permits.
- Increase the depth and liquidity of capital markets through listing state-owned enterprises on the share market, improving competition for brokerage services and relaxing minimum thresholds for pension fund returns.

Maximising the economic dividends from the creation of the Agency for managing the public asset portfolio on behalf of the state

- Provide a framework to define what should be considered a strategic asset.
- Undertake regular, transparent, quantitative analysis of the costs and benefits of keeping individual assets in state hands. Most importantly:
 - ❖ There should be a bias against holding controlling interests in firms operating in competitive markets.
 - ❖ The two state-owned investment funds, KAD and SOD, must be made more independent of the government and should be reduced to portfolio investors over time.
- Ensure that the privatisations resulting from its assessments are well managed and are supported by the public. This will be most likely if:
 - ❖ Privatisations are sequenced so that the least efficient enterprises and those most easily digested by the markets are privatised first.
 - ❖ Structural separation takes place before privatisation to avoid regulation of unstable market structures.
 - ❖ Privatisations achieve good value for taxpayers. This can be aided by undertaking pre-privatisation valuations, ensuring that share offerings are not underpriced or targeted at particular investor groups for political reasons, bidding for shares is competitive and transparent.
 - ❖ Privatisation is subject to independent oversight and high levels of transparency and accountability.
 - ❖ Legal and regulatory frameworks are put in place to ensure a level playing field in the markets where former SOEs compete.
- Put in place a high quality corporate governance regime for enterprises that remain state-owned and make sure the rights of non-state minority shareholders are enhanced. The state should not be involved in the day-to-day management of SOEs and boards should be composed of experts and professional board members who are independent of the government.

Notes

1. Although an efficiency gap between western European countries and the United States in network industries is to be expected, given Slovenia's inferior level of economic development, the gaps are almost certainly larger than if investment in these industries were more open to western firms and the regulatory environment were more effective.
2. These include: information on legislation, taxes and incentives; information on industrial sites and local suppliers; links with industry and local authorities; and organisation of fact-finding missions, business and investment conferences and trade shows.
3. Social security contribution rates in Slovenia, at 16.1% for employers and 22.1% for employees, are not low by international comparison. To the extent that employees shift higher social security contributions on to employers in the form of higher wages, the costs of labour taxes and contributions would be borne by employers. The *Doing Business* indicator, measured as a share of total labour taxes and contributions paid by employers in gross profits, by itself fails to capture the full burden of labour taxes and contributions. Higher labour taxes and contributions paid by employees would manifest themselves as lower profit margins, if they are shifted on to employers.
4. Although it is not uncommon in OECD countries for the tax system to be biased in favour of debt financing, this feature of many tax systems can encourage some firms to be more leveraged than they can safely absorb, with potential ramifications for financial stability.
5. Under the Balassa-Samuelson effect, if productivity growth in the traded-goods sector is more rapid than productivity in the non-traded goods sector, wages will grow more quickly in the non-traded goods sector than productivity. However, there is only weak evidence that the Balassa-Samuelson effect holds in Slovenia.
6. Also, the Agency will exercise the voting rights of the funds in the companies in which the total accounting value of KAD or SOD investments exceeds EUR 20 million. KAD and SOD will not have any power to dispose capital investments in strategic holdings and can dispose capital investments that exceed EUR 20 million only with the approval of their boards.
7. Under EU competition legislation the rationale for holding many public assets disappears because it is illegal for governments to provide support for state-owned enterprises that distorts competition.

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ANNEX 3.A1

Methodological Appendix¹

Data Envelope Analysis (DEA)

DEA is a mathematical linear programming technique developed by Charnes *et al.* (1978). For a given set of firms the technique allows the analyst to define an efficiency frontier from those firms which use comparatively less inputs and more outputs under a constant returns to scale production function. However, because banks often face non-constant returns to scale, Banker *et al.* (1984) included an additional convexity constraint that helps to ensure that only similarly sized firms are compared.

Denoting x as the input variables and y as the output variables, the two models are then:

Constant returns to scale

$$\begin{aligned} \min_{\theta, \lambda} \theta_i \\ \text{s.t.} \quad & \sum_{r=1}^N y_{mr}^t \lambda_r^t \geq y_{mi}^t \\ & \sum_{r=1}^N x_{kr}^t \lambda_r^t \leq \theta_i x_{ki}^t \\ & \lambda_r^t \geq 0 \end{aligned}$$

Variable returns to scale

$$\begin{aligned} \min_{\theta, \lambda} \theta_i \\ \text{s.t.} \quad & \sum_{r=1}^N y_{mr}^t \lambda_r^t \geq y_{mi}^t \\ & \sum_{r=1}^N x_{kr}^t \lambda_r^t \leq \theta_i x_{ki}^t \\ & \lambda_r^t \geq 0 \\ & \sum_{r=1}^N \lambda_r^t = 1 \end{aligned}$$

At any time t , there are N firms that use a vector of inputs (x_1, x_2, \dots, x_k) to produce a vector of outputs (y_1, y_2, \dots, y_m) . $\theta_i \leq 1$ is the scalar efficiency score for the i -th firm. If $\theta_i < 1$, the firm is inefficient and needs a $1 - \theta_i$ reduction in the input levels to reach the efficiency frontier $\theta_i = 1$.

Stochastic Frontier Analysis (SFA)

SFA is a regression technique introduced by Aigner *et al.* (1977), which postulates that the error term in an estimated production function ε_i is made up of two independent components, $\varepsilon_i = v_i + u_i$. $v_i \sim N(0, \sigma_v^2)$ is a two-sided error term representing the usual statistical noise and u_i is a one-sided (positive or negative) term representing technical inefficiency measuring the estimated shortfall of profit or excess costs for a particular firm.

In our case, the estimated equation is:

$$\ln C_i / P_i = c(y_i, w_i, z_i) + v_i + u_i$$

C_i and P_i representing total costs and total net profit of firm i respectively, y_i being the vector of outputs, w_i the vector of input prices and z_i the vector of environmental variables.

The estimation of both cost and functions require a specification of the functional form. We choose the translog functional form, which is widely used in the literature.² The model then becomes:

$$\begin{aligned} \ln C_i / P_i = & \ln \alpha + \sum_j \beta_{y_j} \ln y_j + \sum_l \beta_{w_l} \ln w_l + \\ & \frac{1}{2} \sum_j \sum_r \beta_{y_j y_r} \ln y_j \ln y_r + \frac{1}{2} \sum_l \sum_m \beta_{w_l w_m} \ln w_l \ln w_m + \\ & \sum_j \sum_l \beta_{y_j w_l} \ln y_j \ln w_l + \sum_k \beta_{z_k} z_k + v_i + u_i \end{aligned}$$

If the estimates of the error terms ε_i are easily obtained, both estimates \hat{v}_i and \hat{u}_i must be separated. In the half-normal case, assuming $u_i \geq 0$, i.e. $u_i \sim N^+(0, \sigma_u^2)$, Jondrow *et al.* (1982) show that an estimation of u_i can be given by:

$$E(u_i | \varepsilon_i) = \frac{\sigma_u \sigma_v}{\sigma} \cdot \left[\frac{f\left(\frac{\varepsilon_i \lambda}{\sigma}\right)}{1 - F\left(\frac{\varepsilon_i \lambda}{\sigma}\right)} - \left(\frac{\varepsilon_i \lambda}{\sigma}\right) \right]$$

Where $\lambda = \sigma_u / \sigma_v$, $\sigma^2 = \sigma_u^2 + \sigma_v^2$ and f and F represent the standard normal density and the cumulative distribution function. The efficiency score is then obtained as follows:

$$eff_i = \exp(-\hat{u}_i)$$

Modeling banks' production function and data

There are several ways to model banks' production function, depending on how the economic function of banks is defined. The most commonly used approaches are the intermediation approach and the value added approach. The first approach views financial institutions as being mainly mediators of funds between savers and investors, whereas the second approach focuses on how they use labour and capital to produce deposits, loans and other assets. We use both approaches in our study (Table 3.A1.1).

Table 3.A1.1. **Variables used**

	Value added approach	Intermediation approach
Outputs	Total deposits	Total loans
	Total assets	Total securities
	..	Other earning assets
Inputs	Price of labour ¹	Price of labour ¹
	Price of fixed assets ²	Price of fixed assets ²
	..	Price of borrowed funds ³

1. Personnel expenses/total assets.

2. (Total operating expenses – personnel expenses)/total fixed assets.

3. Total interest expenses/total deposits.

We use individual data from Bankscope for the years 2002 and 2008. Bankscope is a widely used database containing detailed information about banks all around the globe. Under the SFA method, environmental variables are added to all specifications to control for individual bank and country characteristics, and the structure of banking industry (Table 3.A1.2).

Table 3.A1.2. **Environmental variables**

Variable type	Variable	Variable description
Individual characteristics	Market share	Market share as measured by total assets
	Net interest margin	Net interest income over total assets
Structure of banking industry	Intermediation ratio	Ratio of total banking sector loans to total deposits of the banking sector
	Hirschman-Herfindahl index	Index of market concentration, measured by the sum of the square market share of each firm on a national level
Country level characteristics	Number of banks	..
	Population density	..
	GDP per capita	..
	EU post accession	Dummy variable indicating EU post accession (2004)

GDP and population density are extracted from the OECD Economics Department Analytical Database. We chose to download data from Bankscope directly in euros, whereas macro GDP is in national currency. We then convert the data using the IMF yearly average exchange rates.

Bank selection process

The original sample contains over 100 000 observations (16 218 banks are listed over the 2002-08 period). We proceed as follows for the data treatment:

- We exclude non-European countries.
- In some cases, two observations can contain redundant information, one being the consolidated statement, the other one the unconsolidated statement. Therefore, when both are available, we keep the unconsolidated statement, otherwise we keep the consolidated data.
- We eliminate central banks and dissolved banks.
- We eliminate incoherent observations (for example an observation where the loans to assets ratio is superior to 1) and observations with missing data.

Our sample finally contains the number of banks listed in Table 3.A1.3.

Table 3.A1.3. **Number of banks**

	2002	2008
Intermediation approach	2 278	3 515
Value added approach	2 459	3 746

Results of analysis

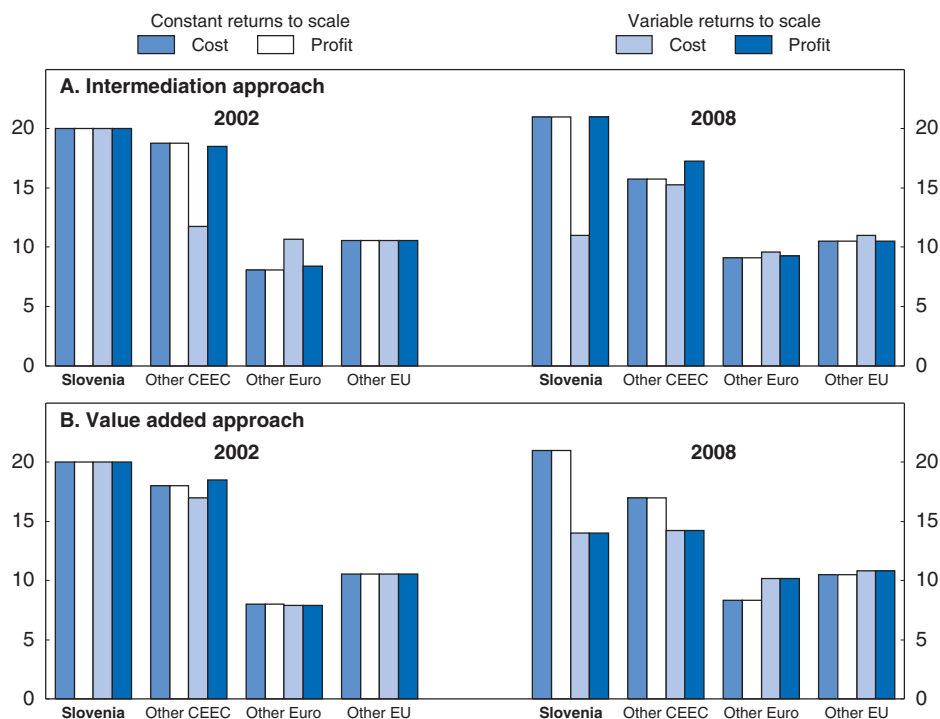

Table 3.A1.4. Slovenia efficiency rankings

Returns to scale		Cost efficiency frontier ¹		Profit efficiency frontier ²	
		2002	2008	2002	2008
Stochastic frontier analysis					
Intermediation approach	Constant	20	20	21	21
	Variable	20	20	11	21
Value added approach 1	Constant	20	20	21	21
	Variable	20	20	14	14
Value added approach 2	Constant	20	20	20	20
	Variable	20	14	20	21
Data envelope analysis					
Intermediation approach	..	14	7	14	15
Value added approach 1	..	21	8	8	14
Value added approach 2	..	19	14	5	15

1. The minimum expenditure required to produce a given bundle of outputs, given the price of its inputs and the technology used.
2. The maximum profit that can be generated given the price of inputs and outputs and the technology used.

Figure 3.A1.1. Data envelope analysis

Ranking among 21 countries

StatLink  <http://dx.doi.org/10.1787/888932369752>

Notes

1. Dimitri Bellas provided research and drafting for this annex.
2. An alternative would be to use Fourier's functional form, which increases the number of parameters. However, as Berger and Mester (1997) show, the results in terms of banking efficiency are very similar.

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