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STATE OWNERSHIP IN THE SLOVENIAN ECONOMY: PROGRESS FROM CATASTROPHE?

Nicholas Ivers



Introduction

In times of recession or slow growth, policy discourse tends to focus on short-term challenges, such as reducing unemployment, achieving fiscal stability, and promoting real growth. The Eurozone crisis (2009–present) and ensuing recession have undeniably afflicted Slovenia’s economy, and much of the problem can be traced to a set of interrelated factors that are outside the direct control of Slovenian policy makers, including the international financial crises, contraction of foreign markets, and the actions (or inactions) of the European Central Bank. However, Slovenia’s impressive pre-crisis growth rates and the undoubtedly international causes of its recent downturn should not serve to shield inefficient domestic policies from attention and correction.

Relative to other formerly socialist Central and Eastern European countries, Slovenia has a large state presence in its economy, mostly in the form of state-owned enterprises

(SOEs). While there are scenarios under which state ownership may be the best option, these tend to involve cases in which market failure is unavoidable, such as natural monopolies. The Slovenian state-owned sector, on the other hand, is a relic of Slovenia’s political history, providing more cost than benefit. This article explores why that state sector persists in its present bloated form and what reforms, if any, are both economically effective and politically possible.

The Extent and Consequences of State Ownership

Slovenia’s version of market capitalism is unique among the former socialist countries of Eastern Europe. While private enterprise now accounts for the majority of economic activity, a uniquely large portion of the Slovenian economy remains state controlled. In 2011, SOEs accounted for one-sixth of value added in the Slovenian economy. State ownership

is concentrated in sectors dominated by larger corporations, notably finance, energy, and telecommunications. During the same year, 11 percent of the Slovenian labor force was employed by SOEs (Georgieva and Riquelme, p. 2). Both economic theory and research suggest that such a pronounced state presence in production can be expected to have adverse economic consequences. SOEs are generally inefficient relative to privately owned corporations for two related reasons. First, SOEs compromise the incentives that motivate firms to produce as efficiently as possible. Second, in place of profit maximization, political incentives drive SOE decision making and these are at odds with economic efficiency in most realistic scenarios. In Slovenia, state ownership has had an obvious impact on the economic landscape. Patronage and corruption are common, and resistance to open privatization has resulted in a domestic banking sector dominated by inefficiently small firms. Currently, a combination of foreign pressure to improve Slovenia's fiscal balance and popular disillusionment with the old system may provide an opportunity for effective reform. In 2013, the government committed to privatizations of some important enterprises but left a large portion of the economy in state hands. A more extensive privatization policy is desirable.

A Brief History of Privatization in Slovenia (1991–2013)

The early 1990s saw the end of the socialist era and the rebirth of capitalist institutions in Eastern Europe. Over the course of the next decade, the formerly socialist nations adopted and adjusted to market capitalism with varying degrees of success. Russia's economy, for instance, collapsed. Its GDP fell by nearly 44 percent between 1989 and 1999 and did not reach pre-transition levels until 2008. Other nations, such as the Czech Republic and Poland, also experienced economic contraction during the beginning of the transition period but were able to recover and achieve strong growth by the middle of the 1990s. Situated on the western border of socialist Europe, Slovenia was never fully disengaged with Western Europe, economically or culturally, and the nation's extant institutions were better suited to

the reintroduction of market capitalist economy than most other formerly socialist nations. As a result, the transition period in Slovenia was among the easiest; GDP per capita levels reached pre-transition levels by the middle of 1998 (Trading Economics). A period of rapid economic growth that lasted until the global financial crisis of 2007–2008 followed. Nevertheless, the market capitalism that has emerged in Slovenia has not been without significant institutional flaws.

The Transition Period

In November 1992, the Slovenian government passed the Law on the Transformation of Social Ownership, and its provisions included elements of both decentralized privatization and mass privatization.¹ The law allocated roughly 40 percent of shares in the nation's larger enterprises to three state funds: the Pension Fund (Kapitalska Družba [KAD]), the Restitution Fund (Slovenska Odškodninska Družba [SOD]), and the Development Fund, although the purpose of the Development Fund was to prepare corporations for eventual privatization. Small enterprises, on the other hand, tended to be privatized internally. Managers and sometimes workers could acquire discounted shares of the enterprises for which they worked. Shares not allocated to the state funds or stakeholders were distributed through a voucher process, either through direct auction or by way of the Development Fund (Mencinger, p. 8).

Although mass privatization was advertised as a way to distribute equity broadly and fairly, the Slovenian market began to consolidate soon after the formal privatization of 1993–1994. The state proved unwilling to divest itself of shares that were originally earmarked for ultimate privatization. As a result, the three major state funds reduced only the breadth of their portfolios, not their size. This was partially due to the public's expressed

¹Decentralized "auction privatizations" occur when a state sells assets on an open market by an auction system. "Mass privatizations," on the other hand, distribute shares to citizens "for free." Auction privatizations tend to be more economically efficient, whereas mass privatizations are more politically attractive and, arguably, more equitable. For a fuller explanation, see Mencinger.

distaste for the selling of public shares to foreigners (Mencinger, pp. 12–13).

Private holding of corporate equity also became more concentrated. Internally privatized firms were sold at discounts to managers and workers; therefore, some individuals were able to capitalize on informational advantages and political connections to acquire valuable property cheaply. On the other hand, many other citizens simply sold vouchers for cash, preferring a short-term consumption boost to saving. The flood of vouchers onto a fledgling market created a glut of equity at a time when that market was illiquid and volatile to begin with (Mencinger, p. 14). As a result, equity offerings were not viable sources of capital for enterprises. Although the situation eventually stabilized, information asymmetry and insider trading have become enduring features of the Slovenian equity market, further reinforcing the high concentration of domestic equity (Mencinger, p. 27).

The 2000s: Leveraged Insider Privatization

Despite the imperfections of the privatization process of the 1990s, the beginning of the new millennium was a prosperous time for Slovenia. The economy grew quickly enough to warrant Slovenia's accession to the European Union (2004), the Organisation for Economic Cooperation and Development (OECD) (2007), and the Eurozone (2007). As the nation became more integrated with Europe, there was pressure from abroad to make the Slovenian economy more similar to that of Western Europe; this entailed reducing the state's role in the economy, particularly as an equity holder.

However, attempts to bring the Slovenian economy more in line with the Western European model faced political opposition, and attempts to sell state-owned banks Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) to foreign strategic investors failed in 2001 (Lindstrom and Piroška, pp. 122–24). Beginning in 2005, the state again began to privatize some state assets. However, this time the sales differed in a key respect from the proposed bank sales of 2001: they were insider privatizations, which meant

that the terms of the sales were negotiated with firms' managers, who became the new owners. On the premise of "national interest," the transactions were strictly domestic; foreign investors were not given the opportunity to bid for shares. The beverage firm Pivovarna Laško, the trading company Mercur, construction firms SCT and Vegrad, and the financial holding company Istrabenz were among the most prominent firms to be privatized this way (Kračun).

The management buy-outs of SOEs during this time were generally facilitated by leverage, and Slovenia's large state-owned banks provided managers with the capital needed to acquire controlling interests in their respective firms. It now seems that these insider privatizations were compromised by political interests and had little economic justification. The OECD credits the relative severity of Slovenia's banking crisis in part to credit misallocation by state-owned banks. It suspects that the banks provided soft funding for buy-outs by politically connected managers, causing high default rates during and after the global financial crisis (OECD, pp. 8–9). Since the crisis, the insider privatizations of the mid-2000s have been called into question, and several former executives have been tried and convicted of "executing illegal instruments," although it is widely understood that their true crime was theft of public property (Kračun).

It is unclear to what extent Slovenia's banking collapse can be attributed to the corrupt insider privatizations. Given the international scope of the financial crisis, it seems likely that the soft lending that fueled the privatizations exacerbated the problem but was not its sole cause. In any case, the state and its banks, which were compliant in the transactions and provided most of the leverage needed, now face one of the highest default rates in Europe. In 2012, 15 percent of loans were non-performing, nationally. Among the large state-owned banks, the figure was 30 percent (OECD, p. 10). Beginning in 2013, in an effort to stabilize the banking system, ownership of non-performing assets was assumed by the "bad bank," which was instituted expressly for the purpose of restoring solvency in the banking system (Majnardi, "Bad Bank Ready...").²

SOEs, the Slovenian Economy, and Political Patronage

State-Owned Enterprises

As explained previously, SOEs have played a major role in the Slovenian economy since the transition era. A company that is an SOE is wholly or partially owned by the state. There were at least 80 such firms in Slovenia as recently as 2011, accounting for approximately one-sixth of economic value added per year (Georgieva and Riquelme, p. 2). The government does not have a controlling interest in all of them. The firms that are generally associated with the term “SOE” tend to be relatively large and state controlled, meaning that the state is a key shareholder, holding nearly 50 percent or more of their shares. Notable examples include the country’s two largest banks, NLB and NKBM; communications firm Telekom Slovenije; and the greater part of Slovenia’s energy industry. Until 2008, Slovenia’s SOEs were financially stable, contributing dividends to the treasury each year (Kračun).

However, even well functioning state ownership is most often inferior to private ownership when measured in terms of economic efficiency. A large volume of empirical work has been devoted to determining the performance of SOEs relative to privately owned corporations. In OECD countries, privatizations have generally produced economic improvements, leading to increased profitability, efficiency, and productivity (Megginson and Netter, p. 31). Perhaps surprisingly, the record is similar across a wide variety of institutional contexts; privatization and open equity markets are associated with better firm performance in both the transitional/developing countries and in OECD countries (Boubakri et al.). In the two decades since its initial privatizations commenced, Slovenia has evolved, moving from the former category to the latter category; yet the gains from privatization have not yet been fully realized.

²The bad bank’s primary function is to act as a depository for bad loans in the Slovenian banking system. It is analogous to the Emergency Economic Stabilization Act of 2008 in the United States, which permitted the U.S. treasury to purchase toxic assets in an effort to provide liquidity for the financial system.

The Political Roots of Inefficiency

In addition to providing empirical analyses of SOE performance, economists have attempted to explain why state-owned firms underachieve in so many different industries and institutional contexts. During the transition era, economists Andrei Schleifer, Maxim Boycko, and Robert Vishny developed a framework that provides useful general insights. The key idea is that politicians are not profit maximizers in the way that private shareholders are. Instead, their primary incentive is to win elections. Thus, when a state owns firms and politicians run them, resources are allocated in a way that maximizes politicians’ likelihood of accomplishing that goal (Schleifer et al., p. 311). The full potential of the market system is not realized.

In their framework, Schleifer and colleagues suggest that politicians use their controlling power to over-employ, meaning that they pay above-market wages or hire more workers than would a profit-maximizing firm. In doing so, politicians can create a dependent interest group. If the public is uninformed or unable to grasp the detrimental effects of over-employment and if patronage is an effective way to gain votes, then the politician loses little but gains much by this behavior. In essence, through SOEs politicians have the ability to provide a hidden wage subsidy to interest groups that, if done explicitly and openly, would come with a greater political cost.

Unfortunately, applying the theory of Schleifer and colleagues directly to Slovenian SOEs is difficult. Reality lacks the neat simplicity of theory. The conceptually convenient idea of over-employment, for example, is too narrow. In Slovenia, patronage could conceivably flow through a variety of channels: contracts with other firms, allocation of lucrative managerial positions, employment of redundant employees, and allocation of savings on the basis of political connections rather than financial merit (in the case of state-owned banks), to name a few. Understanding how patronage is dispensed is critical if reform is to be effective.

The Rent-Seeking State

In Slovenia, the root of inefficiency in

the state-owned sector is political; this much is consistent with the Schleifer-Boycko-Vishny model. Control of Slovenian SOEs has been an economic and political asset to politicians since the 1990s. Corporate governance has been so entwined with national politics that one economist, Mitja Steinbacher, calls Slovenia “a rent-seeking state.”³ He explains that managerial control tended to change hands after changes in the distribution of power in Slovenian politics (Steinbacher). Steinbacher’s view is consistent with the views of other experts. As economist Jože Damijan explains, “The old elite came back to power (in 1992) and stayed there for an additional 12 years. Its main focus was on protecting the economic interests of the elite and to extract the rents from the companies controlled directly or indirectly by the state” (Damijan). The system was stable until a newly elected government, led by Janez Janša and representing those scorned by the old elite, came to power in 2004. Despite seeing itself as representing the victims of the old elite, the new government did little to nothing to mitigate rent seeking. Rather, as Damijan states, “Their goal was not to change the institutional system, to improve the incentives, to lift the regulation or to privatize the companies to foreigners” (Damijan). Instead, they appointed supporters to supervisory and management boards to cement their control of SOEs. In turn, control of SOEs enabled the new government to continue the established practice of granting supply contracts to insiders.

Furthermore, according to Damijan, the insider privatizations of the mid-2000s represent another episode of rent seeking. The ascendance of the Janša government coincided with Slovenia’s accession to the EU, and international pressure to restructure the Slovenian government provided a convenient pretext for insider privatization. Managers connected to the Janša government were able to secure cheap loans for management buy-outs (Damijan). The state, by way of the banks that it owned and controlled, assumed an inordinate amount of risk in the name of domestic privatization. This process effectively transferred

wealth from the public to recipient managers of soft funding.

The Role of Ideology and Economic Nationalism

Ironically, one of the main reasons that state ownership and rent seeking have gone uncorrected by the democratic process is that the Slovenian public, which has the most to gain from effective reform, is resistant to the open auction privatizations that represent the best option. Perhaps because of being subject to culturally distinct foreign powers for much of its history, Slovenians are generally averse to anything that may lead to undue intrusion by outsiders in their domestic affairs. This attitude extends to the economy—economic nationalism, or the idea of “national interest,” persists in Slovenia. The main feature of this doctrine is a resistance to the takeover of domestic firms by foreigners; it is feared that foreign ownership would lead to a loss of economic and political sovereignty.

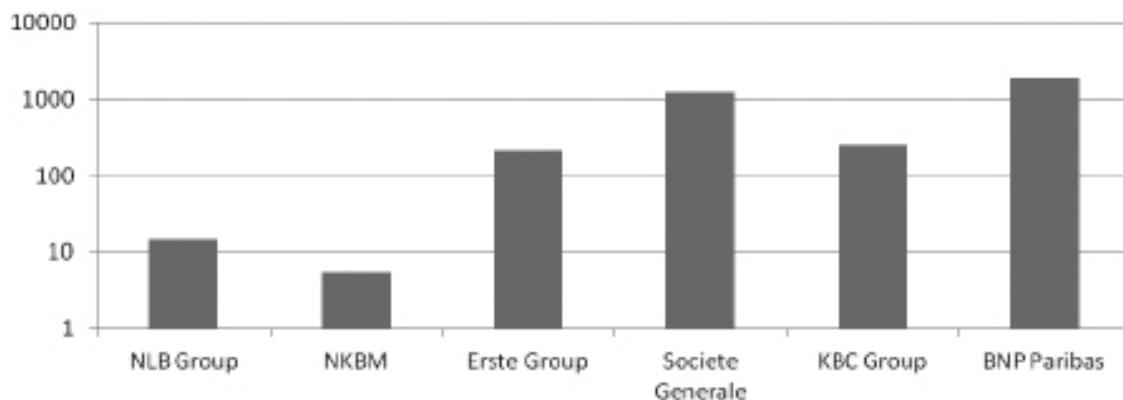
The national interest concept has influenced economic policy on several occasions. It was invoked during the 1990s, when the first wave of privatization began, and again during the 2000s, when Slovenia became more integrated into the EU. Economist and former Minister for Economic Relations Davorin Kračun views the policy of national interest as a manipulation of the public’s patriotism. The primary alternatives to foreign ownership were continued state ownership and domestic insider privatization, both of which tended to favor whoever held political power at a given moment in time (Kračun).

Perhaps the best illustration of the national interest doctrine came during the attempted privatizations of Slovenia’s two largest state-owned banks. In 2001 the government formed a plan to privatize the majority of shares of the nation’s two largest banks, NLB and NKBM. Sixty-four percent of each bank was to be sold to foreign strategic investors. The proposal was met with public backlash and political opposition. The Maribor region, in particular, resisted the sale of “its” bank, NKBM. By 2002, only a minority stake in NLB had been sold to the Belgian bank KBC (Lindstrom and Piroška, pp. 122–24). In the end, the state retained a

³“Rent seeking” is the use of political or economic influence to increase one’s own wealth without creating additional wealth.

Figure 1

Total Assets in Billions of Euros (2012)—Select European Banks



Note: Y-axis is logarithmic.

Sources: NLB Group, Nova KBM, Erste Group, Societe Generale, KBC Bank, and BNP Paribas.

controlling interest in both banks.

The Slovenian Banking Sector

The banking sector also provides an illustration of how state ownership can affect market outcomes. Together, NLB and NKBM, Slovenia's two largest banks, control approximately 35 percent of the banking market. In the third and fourth positions are two more state-owned banks, SID Bank and Abanka Vipava, each holding a market share of approximately 9 percent ("Market Shares of Biggest Banks in Decline"). Figure 1 shows that, by European standards, both NLB and NKBM are quite small. Most other European banking markets are dominated by much larger multi-nationals. The chart compares the asset values of Slovenia's largest banks (NLB and NKBM) to those of several major Europe-based multi-national banks.

Recent empirical work by Mark Dijkstra suggests that the extent of consolidation in European banking has valid economic foundations. Bank size roughly matches models of scale economies, although this may be partly explained by an implicit "too-big-to-fail" subsidy (Dijkstra). Another study, using a data set of American banks, finds that when risk is modeled within the profit function, large banks face economies of scale at their current sizes

even when too-big-to-fail effects are ignored, suggesting that economies of scale have traditionally been underestimated in banking (Hughes and Mester). Regardless of the exact extent of scale economies, it is reasonable to conclude that Slovenia's "large" state-owned banks, which are one to two orders of magnitude smaller than the major European multi-nationals, fall well short of efficient scale.

In a well-functioning capital market, small-scale inefficiencies are corrected by mergers, acquisitions, or some other means of consolidation. In Slovenia, this would likely entail the purchase of NLB and NKBM by foreign-based multi-nationals. Indeed, the Belgian bank KBC's successful bid for NLB in 2001 was derailed by a political backlash. In effect, economic nationalism, combined with political incentives, has allowed state ownership to continue where strategic foreign investment would produce a more efficient economic outcome.

Unfortunately, this is indicative of the state presence in the Slovenian corporate sector in general. Political factions are incentivized to keep the status quo, because it allows them to seek rents when they are in power. At the same time, the democratic process does not correct the problem, because the public opposes the open auction privatizations that would offer the easiest solution. Economist

Jože Damijan suggests that this deleterious balance may only be broken by foreign pressure (Damijan).

Recent Reform Legislation

2011–2012

In 2011, the OECD issued a report endorsing Slovenia's then recently drafted "Action Plan for Corporate Governance Reform," which included the Corporate Governance of State Investments Act. According to the report, "Slovenia has taken significant steps to improve the governance of its SOEs" (OECD, p. 2). The crucial legislative component of the law was the establishment of a central ownership agency, AUKN (translated loosely as the Asset Management Fund of Slovenia). This agency was established to take direct control of the government's shareholding role, previously dispersed among many independent, disparate, and nontransparent ministries. The OECD and Slovenian lawmakers anticipated that corporate governance of Slovenia's SOEs would become more transparent as a result. Greater transparency would, in turn, reduce the role of politics in corporate decision making.

The plan failed. Following a shift in political power in 2012, AUKN became embroiled in controversy. In November the head of the agency, Janez Benčina, stepped down, citing "personal reasons." However, the Slovenian newspaper *Delo* speculated at the time that the resignation was in fact a result of political pressure (Majnardi, "Total Mess in State-owned Capital Asset Management"). Economist Davorin Kračun thinks similarly; the agency, which was established and staffed during the previous government, simply did not play into the hands of the ascending coalition. Instead of working with the agency, the new government dissolved it in 2013 (Kračun).

2013–Present

Having accumulated a large fiscal deficit, the Slovenian government continues to face pressure from abroad to improve its public finances, even as the nation's economy teeters between stagnation and recession. The sale of assets in select SOEs is one potential way to al-

leviate the fiscal situation. In fact, during the early months of 2013, the government resolved to carry out a limited privatization of state assets. Several important SOEs, including Telekom Slovenija, NKBM, NLB, and Adria Airways, are expected to be sold to foreign investors, although the time frame remains uncertain. Government officials have promised to carry out the privatization in a transparent manner, perhaps reflecting the public's resentment over the insider privatizations of the 2000s (Majnardi, "15 State Companies Listed for Privatization"). The state will relinquish its controlling interest in those firms deemed "portfolio investments." The state will retain 5 percent and 25 percent stakes in "strategic" and "important" enterprises, respectively, which means that the plan is far from a full liberalization of the economy (Majnardi, "Government to Sell off State-owned Companies"). The majority of the current state-owned sector will remain at least partially state controlled (Rousek). As of January 2014, the financial firm Lazard Freres has been officially hired as a consultant in the sale of NKBM, so it appears that the privatization plan is in motion (Majnardi, "Lazard Freres Adviser in Privatisation of NKBM Bank").

As the current privatizations continue to develop, policy makers are once again attempting to consolidate the state's shareholding power under a single agency. In place of the defunct AUKN, this time the central agency will be Slovenian Sovereign Holding (SSH). The exact framework is delineated in a Sovereign Holding Bill. As of December 2013, the bill proposes to merge the Pension Fund (KAD) with the Restitution Fund (SOD), resulting in the creation of a new extended state holding agency (Majnardi, "Sovereign Holding Bill Adopted Despite Opposition of Pensioners"). In the preliminary meetings held in January 2013, top parliamentary officials and proponents of the plan emphasized the need for independence. Top positions are to be reserved for technocrats with limited affiliations to political parties. Of course, this resolution echoes the goals, articulated just over two years ago, of the failed Corporate Governance of State Investments Act.

Policy Assessment

The Slovenian government is pursuing

two market reform strategies: privatization of select SOEs and consolidation of the state's role as a key shareholder in national enterprises. The current strategies represent a marginal improvement for the Slovenian economy in the long run, but they are motivated more by fiscal necessity and leave much to be desired.

The privatizations will be open to foreign investors, and some sales will see the elimination of the state's controlling interest. This is an improvement over previous privatizations, which either sold only minority stakes to foreign investors or excluded them completely in favor of domestic buyers. Of particular importance are the sales of the two largest state-owned banks, which will modernize Slovenia's notoriously inefficient financial system. However, the state will retain large stakes in the majority of SOEs; the era of direct state influence in resource allocation is far from over.

The second reform, the creation of SSH, aims to improve the corporate governance of the firms that are to remain state owned. It is hoped that the centralized agency, by appointing experts rather than politicians to execute the state's function as shareholder, will bring a new level of transparency, efficacy, and competency to the boards of Slovenian SOEs. While admirable in principle, SSH is similar to AUKN, which did not survive the previous political cycle.

Even if the agency is able to survive its infancy, it is questionable whether it can uphold the standard of virtuous technocracy that it is supposed to. In all likelihood, appointments will still be decided by elected officials, so the established channel of rent seeking will not be broken. Leaving decisions to true experts could well increase the competency of SOE boards, but what constitutes expertise is subject to a broad range of interpretation. Moreover, expertise and corruption are not mutually exclusive. Everyone reacts to the right incentives.

It may be argued that SSH, by providing a higher degree of transparency than the previous system, will allow the democratic process to more effectively identify rent seeking and elect officials that take steps to eliminate corruption. This is doubtful for two reasons. First, rents can be allocated subtly. If an SOE reaches a supply contract with another firm, how is the public to determine whether the decision was

made competitively or for political gain? The cost of monitoring such low-level decisions would be prohibitively high. Second, there is no convenient yardstick to measure efficiency relative to a hypothetical private ownership scenario. In the private sector, competitive capital markets allow the economy to have its own built-in check on corporate performance. If a company is poorly run, it is vulnerable to takeovers that transfer decision-making power to those who can make better use of a firm's capital. The market provides no such test for SOEs, because the government will have an inclination to hold onto its controlling interest even if potential bids for shares exceed the present financial value of those shares. Share prices are also useless, because movements react to expectations; and, if a firm is state owned over multiple time periods, there is no easy way to assess the effect of state ownership on performance. Economists are able to use sophisticated econometric techniques to do so, but it is questionable whether the public would be willing or able to factor such research into voting decisions.

Conclusion

With channels of rent seeking intact, no reliable monitoring system, and no useful metric of performance, it is unlikely that consolidating the state's shareholding responsibilities under SSH will solve the fundamental problem with SOEs: inefficiency due to weak incentives and the presence of opportunities for rent seeking. From an economic standpoint, Slovenia would be better off privatizing the majority of its state-owned assets, rather than just a small fraction. Although such a solution would have been politically impossible just a few years ago, it is conceivable that the fiscal situation, which makes some key privatizations necessary in the near term, combined with continued pressure from abroad may create the conditions necessary to move further toward this end. Economist Davorin Kračun believes that recent events, in particular the fallout from the insider privatizations of the 2000s, have increased the level of disillusionment with the old system (Kračun). Whether popular frustration can be channeled in the proper direction remains to be seen.

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