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Slovenia: The End of a Success Story? When a Partial Reform Equilibrium Turns Bad

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"I had no real collateral for a deal of that size. Just my house, a few hundred thousand euros, a smart business plan and my reputation." Bine Kordež
(on getting a 350 million Euros loan for the buyout of Merkur, a home-improvement chain)

Abstract

During the Great Recession, Slovenia recorded one of the worst economic performances within the EU. Such decline is surprising as the country was the most stable among post-socialist states. The article individuates the root cause for the downfall in protracted reform gradualism, which resulted in an inefficient privatisation process. This locked the country into a *partial reform equilibrium*, where economic elites extracted rents. Following the accession to the EU, the unsustainable lending practices of state-owned banks to corporates and the gridlock in policymaking pushed the country into an economic and political *bad equilibrium*. Still now, a massive debt overhang and a huge reform backlog are preventing a healthy recovery.

1 Introduction

By mid-2014, Slovenia is politically and economically in a shambles. In July, Miro Cerar, head of the two-months-old leftist Party for Miro Cerar (SMC), became the winner of the latest Slovenian parliamentary elections. As Prime Minister, he formed the fifth government since the beginning of the Great Recession. The previous executives clearly mishandled the crisis and even though the financial markets' grip eased during 2014, Slovenia seriously risked becoming the next in line for an international bailout. This is puzzling for a country that until recently was considered the most prosperous and stable among post-socialist states, and requires an informed explanation.

Slovenia had always been an outlier within the former Eastern bloc. It was the most developed of the six Yugoslav republics and Slovenians were considered to be orderly and law-abiding. According to an old adage, *"laws were written in Belgrade, read in Zagreb and implemented in Ljubljana"*. The transitions to democracy and a market economy, as well as the accessions to the European Union (EU) and the Economic and Monetary Union (EMU) were all relatively straightforward. After a brief transformational recession, Slovenia's GDP recorded high growth rates, and its per capita income rapidly converged to the EU average. Economic development, mainly the result of 'competitive neocorporatism', was not achieved at the expense of social justice: inequality was comparable to Scandinavia, the unemployment rate was low and the gender gap with respect to earnings narrower than the OECD average.

The picture, almost seven years into the Great Recession, is instead desolating. Slovenia has been stuck in an inextricable credit crunch since 2009. After accessing the EU, (mainly) state-owned banks irresponsibly channelled cheap credit to the corporate sector, taking loans from foreign financial institutions on the interbank market. These loans financed management buyouts (MBOs), and fuelled bubbles in real estate, construction and the stock market. Once the global financial crisis hit, widespread bankruptcies and the need to refinance the Slovenian banking sector followed. The country's GDP collapsed, unemployment more than doubled and public deficits mounted. Slovenia swiftly became one of the worst performers within the EU-28. The Eurozone's sovereign debt crisis dealt the *coup de grace*. In order to avoid a rescue-cum-retrenchment package, the government headed by Premier Alenka Bratušek had to inject funds worth some 10 per cent of GDP to recapitalise Slovenian banks that were buckling under the weight of non-performing loans (NPLs). A severe debt overhang in the corporate sector and a burdensome backlog of structural reforms have prevented a healthy recovery.

If the dynamics of the downfall are clear, this article's aim is to untangle the reasons for it to happen. Back in the early 1990s, following the transformational recessions in Central and Eastern Europe (CEE), a heated academic debate erupted between the proponents of shock therapy (Balcerowicz 1994; Sachs 1994) and gradualism (Murrell 1995; Przeworski 1991; Stiglitz 1999).[i] The main assumption supporting the superiority of a gradual approach is that it produces winners in the short term who gain a stake in the reform process, whose momentum they sustain and whose achievements they defend. However, such argument can be turned on its head. Hellman (1998, pp. 204-5), among others, warns that gradualism may have negative long-term consequences as *"short-term winners [may] stall the economy in a* partial reform equilibrium *that generates concentrated rents for themselves, while imposing high costs on the rest of society"*.

In line with such reasoning, this article contends that Slovenian gradualism, praised by several authors as the reason for the country's success (Mencinger 2004; Bohle and Greskovits 2012), turned to be a double-edged sword that in the long-term triggered its collapse. The gradual transition of the early 1990s not only generated economic growth but also preserved social peace and maintained social equality in the face of transition. However, in the long run it resulted in the dilution of much-needed reforms. An inefficient privatisation programme – Slovenia's original sin – advantaged a managing elite, the *tajkuni* (tycoons), i.e. the 'short-term' winners, thereby locking the country in a *partial reform equilibrium* consisting of distorted management and lending practices. In the name of defending national interests, the privatization of state-owned enterprises (SOEs) and of state-owned banks (SOBs) had slowed down, effectively cutting out foreign investors, concentrating the Slovenian economy in the hands of a few politically-connected (and controlled) managers and bankers (Damijan 2007).

If protracted gradualism set the stage, two shorter-term occurrences contributed to the unexpected downfall. First, the flood of cheap credit that inundated the Slovenian financial system since the accession to the EU became an opportunity not to be missed for managers to consolidate their ownership stakes through MBOs. Given the political interference with and the corporate governance problems of domestic, mainly state-owned banks, credit misallocation to financial holdings and the construction sector was pervasive (OECD 2013, pp. 48-50). Ineffective regulatory, judicial and banking supervision failed to nip in the bud the mounting indebtedness of the Slovenian corporate sector, which culminated in a twin banking and sovereign debt crisis.

Second, policy paralysis became a steady feature of a polarised political system, where neocorporatism exhausted its élan. Since the Yugoslav breakup, consensual decision-making and broad coalition building were the country's modus operandi. During the 1990s, the left-liberal and right-conservative blocs saw their ideological differences compressed by the common goal of EU accession. This changed when Janez Janša of the Slovenian Democratic Party (SDS) won the 2004 elections. The centre-right coalition felt great resentment towards the leftist Liberal Democracy of Slovenia (LDS), which dominated Slovenia politically, culturally and economically for the previous 12 years. Since then, electoral competition became toxic, the relationship with the social partners deteriorated and public protests multiplied. Growing antagonism halted the reform attempts of both Borut Pahor's Social Democrats (SD) in 2011 and Janša's second government in 2013. By then, the country was pushed into an economic and political *bad equilibrium* (Stanovnik, 2013), skipped four years of restructuring and fiscal consolidation, without addressing its banking mess.

Finally, the reason why a healthier recovery did not appear is the long-term weaknesses of the Slovenian economy, a byproduct of the *partial reform equilibrium*. Years before the crisis began, the growth of labour productivity and technological intensity of the country's enterprises slowed down. The availability of cheap credit triggered the collapse. Corporate indebtedness grew exponentially and when the crisis hit Slovenian firms too entered a *bad equilibrium*. Partly as a consequence of the MBOs, little was invested into the upgrading of skills and technology, resulting in labour costs growing out of line with productivity. Moreover, the debt overhang represents a huge drag on growth. Both problems require immediate and resolute policy responses, as Slovenian firms are recovering slower than their major trading partners.

The article is structured as follows. Section 2 presents the most salient features of Slovenia's successes as an independent nation up until the Great Recession. Section 3 decomposes the main factors lying behind the collapse. Section 4 concludes by analysing the future prospects for the tiny republic.

2 The components of a success story

All socioeconomic indicators point into one direction: Slovenia was the most successful amid the post-socialist countries. According to Eurostat, Slovenian GDP grew on average by 4.5 per cent p.a. in 1993-2008. Per capita income rose from less than half of Western Europe to around 90 per cent of the

EU-27 average in 2009. Its public finances underwent only mild deterioration since the early 2000s. Public debt never crept over 27.8 per cent of GDP, the average yearly budget and current account deficits in 1995-2008 were, respectively, 2.6 and 1.5 per cent of GDP (the figures for the four Visegrád countries were 5.1 and 5.3). Low unemployment rates, averaging 6.3 per cent in 1996-2008, and relatively high employment rates, which climbed from 61.7 to 68.6 per cent during the same period (65.8 was the EU average in 2008), underpinned the years of buoyant growth.

At the same time, the country's social safety net underpinned one of the most egalitarian societies in Europe. Due to the redistributive role of the Slovenian welfare state, the Gini coefficient (after taxes and transfers) was 0.246 in 2004, lower than in any other Member State, bar Sweden (OECD.Stat). Despite relatively thrift spending on social protection benefits – not exceeding 23.8 per cent of GDP in 1996-2009, at least 2 percentage points lower than the EU average – the at-risk-of-poverty rate during 2005-08 never surpassed 12.3 per cent, compared to the almost constant EU-27 average of 16.5 per cent.

Slovenia's achievements were supported by a combination of factors rarely present in the rest of CEE: gradualism underpinned by a consensual political system, developed neocorporatist institutions and the partly inherited technologically-intensive industrial production. These are separately analysed in the following paragraphs.

2.1 Gradualism and consensual politics

Gradualism[ii] has highly benefitted Slovenia during its transition to a market economy. The costs in terms of unemployment and social risks were distributed over time; harmed groups were compensated, preventing social unrest and political instability. Reduced uncertainty during the transformational recession improved economic decisions by both the state and individuals, leading to sustained growth without macroeconomic imbalances. Hence, economic, social and political stability in Slovenia were gradualism's remarkable achievements (see Mencinger 2004).

Rojec et al. (2004, p. 461) identify various reasons for such choice: consensual decision-making; the early, endogenous transition; a high starting point of development; the dissolution of Yugoslavia and ensuing unstable politics, which cautioned against shock therapy. The first two are of particular interest for this article.

After its independence, Slovenia developed into a consensual parliamentary democracy. The 1991 Constitution adopted an asymmetric bicameral legislature, where the 90-member National Assembly is vested with legislative power and the National Council has limited veto rights. The 40 members of the second chamber represent key economic interest organisations, an inheritance of the Yugoslav self-managed social partnership (Lukšič 2001, pp. 22-23). Additionally, the Constitution prescribed a Proportional Representation (PR) electoral system with low thresholds that fragments the party system, promotes moderate pluralism and generates coalition governments (Toplak 2006). Under these conditions, Slovenian policymakers have to overcome numerous veto points and are reminded that divisive policymaking is a risky strategy, especially when legislating complex socioeconomic policies, as they face the strongest labour movement in CEE.

During the late 1980s and early 1990s a bipolar division of the political space emerged (Adam, Kristan and Tomšič 2009). The two blocs, left-liberal and right-conservative (parties of the so-called 'Slovenian Spring' of 1987-88), align themselves along three cleavages: socioeconomic issues, i.e. the classical left-right divide, which became prominent only after 2004 (Fink-Hafner 2006), religion, and attitude towards the past (interwar period and socialism).

In 1991, the Democratic Opposition of Slovenia (Demos), representing a hybrid mixture of left-liberal and right-conservative elements, led the country to independence from war-ridden Yugoslavia. After the quarrelsome coalition fell apart, in part due to internal disagreements on the issue of denationalisation (see Prunk, Toplak and Hočevar 2006, pp. 232-246), extraordinary politics gave way to politics as usual. The period 1992-2004 was then marked by the political hegemony of Janez Drnovšek's Liberal Democracy of Slovenia (LDS, since 1994), the successor of the League of Socialist Youth of Slovenia, a reformist socialist faction leading the within-system opposition. After 1994, the Social Democratic Party of Slovenia (SDS, renamed Slovenian Democratic Party in 2003), led by former dissident Janez Janša, became the leader of the right-conservative bloc and the main opposition party.

If the domination of the left–liberal bloc was politically (self-)limited, its cultural, economic and, less so, political elites displayed extremely high rates of reproduction. On the one hand, LDS granted some continuity with the Demos interlude by ruling through broad, ideologically heterogeneous coalitions, building alliances with, for example, the Slovenian People's Party (SLS) (Lukšič 2003, pp. 522-23). Hence, the polarisation of the political space equalled zero until the 2004 elections, a feature shared only by Turkmenistan – for slightly different reasons – in the post-socialist world (Frye 2010, p. 55). On the other hand, the 'endogenous transition' allowed former elites to socialise into the new political system and maintain their pre-transition prominence (Adam and Tomšič 2002). By virtue of its reformist status under Yugoslavia, the old elites managed to adapt to the new system seamlessly (Iglič and Rus 2000), thereby – at least seemingly – not blocking the ongoing transformation (see Róna-Tas 1994).

The result was that the business elites were from the left, while the parties of the Slovenian Spring considered themselves as the transition's losers. As the common goal of acceding to the EU compressed the political space, the potential conflict between the two blocs stayed practically muted for almost 15 years.[iii]

2.2 Competitive neocorporatism

According to most observers, Slovenia evolved into a Coordinated Market Economy (Bohle and Greskovits 2012; Feldmann 2007; Guardiancich 2012b) with some characteristics of managerial capitalism, such as insider ownership and a 'compensating state' (Stanojević 2012; 2014; see also, Hancké, Rhodes and Thatcher 2007). The country developed functioning social dialogue at enterprise and national levels.

Crowley and Stanojević (2011) explain how this happened. First, Slovenia had highly organised social partners, a rare feature in post-socialist countries. They were inherited from Yugoslavia, which, after the Tito-Stalin rift, rejected central planning for self-management, where *"companies were organised in accordance with internal formal structures determining the subordination of managerial functions to employees' collective interests articulated by workers' councils"* (Stanojević 2012, p. 5).

Hence, in 1990, union density was 61.1 per cent, closer to Western European averages than to CEE, and stabilised at some 40 per cent until the accession to the EU (Visser 2011). During early transition the labour movement split along pro- and anti-communist lines and the reformed, socialist successor Alliance of Free Trade Unions of Slovenia (ZSSS) became the largest labour organisation in the country, representing mainly blue-collar workers. As for employer organisations, these are often weak and fragmented in the post-socialist context. In Slovenia this was not the case, as the Chamber of Commerce and Industry of Slovenia (GZS) and the Chamber of Craft and Small Businesses of Slovenia

(OZS), represented all private entrepreneurs during 1991-2006, because of compulsory membership. Moreover, state-owned and state-controlled enterprises dominated GZS, espousing an accommodating stance towards social partnership.

Second, already under Yugoslavia, Slovenia relied on export-oriented firms, which, however, faced during self-management soft budget constraints (Kornai 1992). As the Yugoslav Dinar was not convertible, and hard currency was needed, these firms were exporting even at a loss (and compensating at home, e.g. by letting workers engage in the informal economy). When the Yugoslav internal market disappeared, labour-intensive firms suffered, and as budget constraints hardened, export-oriented enterprises experienced a crisis of competitiveness. Concomitantly, high inflation hit the country, which Demos tried to fight through a wage freeze and the suspension of collective agreements. The unions, especially ZSSS, started a number of disruptive strikes.

When the LDS-led government took power in May 1992, it had to calm the strike wave and tame inflation. Two main concessions were legislated. The Ownership Transformation Act favoured various forms of insider privatization. The state and quasi-state institutions obtained the biggest stake in capital-intensive and export-oriented companies (Simoneti, Rojec and Gregorič 2004, p. 231). Managers acquired a significant portion of the shares allocated to insiders. Instead, fulfilling a firm demand of ZSSS, employees became majority owners in (problematic) labour-intensive sectors (Stanojević 2012, p. 865). The strikes subsided immediately, and the labour movement gained reputation as a responsible bargainer. As wage freezes could be no longer unilaterally legislated, in 1994, LDS engineered a political exchange between incomes policy (centralised wage bargaining that promoted wage moderation) and the institutionalisation of social dialogue through the tripartite Economic and Social Council (ESS).

The consolidation of ‘competitive neocorporatism’ (Stanojević 2014) in Slovenia had two beneficial effects. At the micro level, the Slovenian system of works councils evolved from Yugoslav self-management and was transformed in 1993, mimicking the German *Betriebsräte* (Buchen 2007). Strong (dual) workers’ representation is warranted by firm-level labour union organisations, which operate in the majority of Slovenian firms. The German-inspired dual system of apprenticeship (in firms and vocational schools) and national qualification system provides technologically intensive sectors with the necessary knowhow (see Cedefop 2008). At firm and sectoral levels, management and labour formed ‘survival coalitions’ based on non-conflictual micro-exchanges. In order to stay competitive, work intensity and functional flexibility were compensated with high job security, limitations to dismissals, wage protection and generous pension benefits (Crowley and Stanojević 2011; Stanojević and Krašovec 2011; Stanojević 2012).

At the macro level, institutionalised social pacts favoured competitiveness and economic stability, necessary requirements to comply with the Maastricht criteria. These agreements specify the obligations of the social partners, (partly) set the agenda for an incumbent government, and are the result of collective negotiations over economic, social and wage policy (Stanojević 2010).

During 1994-96, the social partners signed three annual pacts, which represented the basis for the quid-pro-quo between restrictive income policies and the creation of tripartite macro concertation through the ESS. With it, the rather weak LDS-led government included unions and employers into the policy formation process. The run-up to the accession to the EU and EMU started with the unsuccessful attempt to draft a comprehensive pact. Notwithstanding, the unions tacitly agreed to restrictive income policy in 1997-98, in order to de-index the economy. The radical White Paper pension reform proposal triggered mass demonstrations in March 1998 and blocked the drafting of a social pact for 1999. A year later, the agreement on the new labour code elicited less controversy, and an Agreement on Income Policy for 2001-2003 was also successfully hammered out. In 2003, a three-year comprehensive social pact followed, and had a markedly European content: disinflation was given top priority and was achieved through wages lagging behind productivity growth. According to IMAD (2011, p. 90), during 2000-07, real unit labour costs dropped by 0.4 per cent annually, on average.

Bi- and trilateral social dialogue produced positive results: through wage moderation Slovenia swiftly complied with the Maastricht criteria and was the first CEE country to adopt the Euro in 2007; through the upskilling of the labour force it became moderately competitive in technology intensive industries.

2.3 Technology intensive manufacturing

As mentioned above, Slovenia was an outlier already during socialist times: it was the most developed of the Yugoslav republics, it was geographically closest to Continental Western Europe and its economic elite, the ‘red managers’, administered firms, such as Krka and Lek pharmaceuticals, Gorenje home appliances, which dominated the Yugoslav internal market and were, to a certain extent, internationally competitive (Stanojević 2012).

Slovenia's technology intensive manufacturing suffered only a moderate contraction during the transformational recession. The first reliable data using NACE Rev.2 are for 1995 and show that Slovenia had 31.6 per cent of medium-high and high-tech manufacturing on total, employing circa 27.4 per cent of the industrial labour force. Due to the advantages of neocorporatism (skill formation and wage moderation) and coupled with a quarter of all foreign direct investments (FDIs) concentrated in these industries, Slovenian technology intensive firms thrived. The share of complex manufacturing rose to over 41 per cent by 2007, involving one third of the industrial labour force, and the share of complex exports on total rose from 42 to 50 per cent during the periods 1989-98 and 1999-2007 (Bohle and Greskovits 2012, p. 44).

Consequently, just before the Great Recession, the World Bank (2007, p. 24) stated: *"[t]he shift towards higher technology exports is particularly evident in the Visegrád countries and Slovenia."* Bohle and Greskovits (2012, pp. 45-46) label Slovenia as being part of 'semicore' countries in international economic integration; that is, a country where skilled labour and autonomous management are abundant, but which has to rely on external sources (from advanced economies) for technology, capital and global entrepreneurship, and still lacks the skills and sophistication of its Western partners.

In sum, the gradualist approach to transformation backed up by consensual politics and functioning neocorporatism sustained and stabilized the growth of Slovenia's economy and especially of its technologically intensive firms, which became a role model for the rest of CEE.

3 The collapse explained

After more than a decade of real economic convergence to the EU, the Great Recession annulled most of the gains. Within the Eurozone, Slovenia had the worst economic performance in 2009-13, after Greece. As shown in Table 1, GDP in 2009 fell by 7.9 per cent, in 2010-11 the economy failed to rebound, and the country entered a double dip recession in 2012-14. A feeble recovery is expected to generate GDP growth of 1.3 per cent in 2015. Slovenian GDP per capita measured at Purchasing Power Standard has plunged to 83 per cent of the EU-28 average in 2013 from 91 per cent in 2008, the same level as in 2002. The unemployment rate increased from 4.4 to 10.1 per cent in 2008-13. The sole good news is that the welfare state's redistributive functions worked: Slovenia became the least unequal OECD country in 2013 (Gini equalled 0.24).

Table 1 GDP growth and components (2000-13)

	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth (%)	4.3	4.0	5.8	7.0	3.4	-7.9	1.3	0.7	-2.5	-1.1
GDP components										
External trade balance	2.5	2.2	0.2	-2.0	0.1	2.6	1.8	1.0	3.8	1.3
Exports of goods and services	6.2	6.1	7.8	9.1	2.8	-10.9	6.0	4.7	0.4	2.2
Imports of goods and services	3.7	3.9	7.6	11.2	2.6	-13.5	4.3	3.6	-3.4	0.9
Total domestic demand	1.7	1.8	5.7	9.0	3.2	-10.5	-0.5	-0.3	-6.3	-2.4
Household consumption	0.4	1.1	1.5	3.3	1.2	-0.1	0.8	0.4	-2.7	-1.5
Government consumption	0.6	0.7	0.8	0.1	1.0	0.5	0.3	-0.3	-0.3	-0.4
Gross fixed investment	0.7	0.7	2.6	3.5	2.0	-6.8	-3.5	-1.1	-1.5	0.0
Change in inventories	0.0	-0.7	0.7	2.0	-0.9	-4.1	1.9	0.6	-1.8	-0.5

Source: IMAD (2014, p. 97).

The economics underpinning the Slovenian mess are well explained by the European Commission (2013, p. 1): *"Following unsustainable trends in corporate indebtedness and lending practices in the pre-crisis boom years, Slovenia faces risks in corporate and bank balance sheets. […] These risks are compounded by an economic structure dominated by state ownership, insufficient legal framework for corporate restructuring and by limited adjustment capacity in labour markets. […] Uncertainties about the potential contingent fiscal liabilities arising in the banking sector have been a major factor in raising borrowing costs for the sovereign and for the economy as a whole."*

The accession to the EU in May 2004 and EMU in January 2007 triggered an economic boom in Slovenia (Table 1). Low interest rates (Figure 1), which subsided due to the market's faith in the Eurozone, and a massive inflow of foreign funding triggered a lending spree, underpinned by unsustainable financial leverage. The loan-to-GDP ratio increased from 40 to 90 per cent and the loan-to-deposit ratio from approximately 0.95 to 1.64 (OECD 2013, p. 44; IMAD 2014, p. 113).

During the run-up to the crisis, most Slovenian banks, in particular the three major SOBs (*Nova Ljubljanska Banka*, NLB, *Nova Kreditna Banka Maribor*, NKBM, and *Abanka*) started extending massive loans to the corporate sector, which fuelled bubbles (see Damijan 2012b) in real estate (housing prices rose by 51.3 per cent in 2004-07), in construction (gross VA increased by 72 per cent), in the stock market (the market capitalization of shares hit 19.7 billion Euros in December 2007, which is 253 per cent more than in January 2004) and financed numerous acquisitions, many in the form of MBOs. The Securities Market Agency (ATVP 2013, p. 37) reports that 123 out of 223 major acquisitions, which required the regulator's approval according to the 1997 Act on acquisitions, took place in 2004-08 and were worth 2.4 billion Euros.

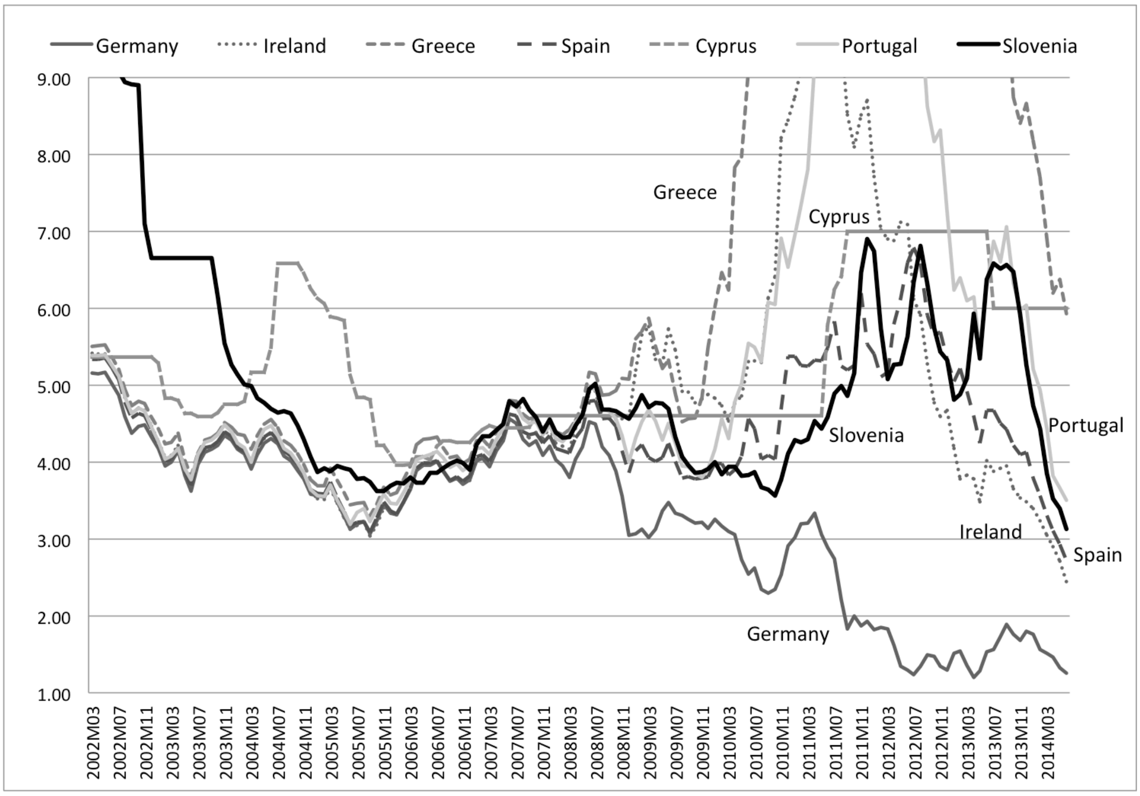
In late 2008, when the Great Recession hit the ex-Yugoslav republic, most Slovenian banks became instantly illiquid. This was mainly due to their method of financing: rather than employing deposit sources, the banks financed their investments through foreign borrowing (the Slovenian net external debt climbed from -3.4 to 30.9 per cent of GDP in 2004-08). Owing to the liabilities to foreign banks becoming due and limited possibilities for their refinancing, Slovenian banks reduced the volume of loans to domestic non-banking sectors. The country *de facto* entered an inextricable credit crunch, which greatly harmed Slovenian enterprises. Only at the end of 2011, liquidity pressures were relieved by the employment of European Central Bank's (ECB) non-standard measures, consisting of long-term funds with a maturity of three years (IMAD 2013, p. 21).

By then, the damage was already done. The collapse of the construction sector, bankruptcies and liquidations in manufacturing exposed the collateral's poor quality and caused the deterioration of bank assets. The asset quality review and stress tests carried out in late 2013 on eight Slovenian banks, representing circa 70 per cent of the banking system (two small banks, Factor banka and Probanka, were already wound down), revealed a capital shortfall under the adverse scenario of 4.778 billion Euros, i.e.

circa 13.5 per cent of GDP of 2012. The three major SOBs (NLB, NKBM, Abanka) alone require a capital injection worth 3.012 billion Euros (Bank of Slovenia 2013).

As in other Eurozone countries under stress, the banking crisis soon triggered a sovereign-debt emergency (on the detailed dynamics, see Pisani-Ferry, 2012). Past recapitalisations and growing concerns over the conditions of Slovenian financial institutions led to the credit rating downgrades of both banks and the state: between 2006 and 2014 from Aa2 (positive) to Ba1 for Moody's; from AA to A- for S&P; from AA to BBB+ (negative) for Fitch (IMAD 2014, p. 109). As shown in Figure 1, Slovenian bond yields (EMU convergence criterion) rose from 3.67 to 6.90 per cent between August 2010 and December 2011, some 500 basis points above the German *Bund*. This severely limited the access to international sources of financing when most needed.

Figure 1 EMU convergence criterion bond yields 2002-14



Source: Eurostat.

The debt-to-GDP ratio more than tripled in five years (Table 2). Three factors, combined with the sharp drop in GDP, contributed to this. First, irresponsible fiscal policy during the buoyant years implied that no savings were made before the crisis hit Slovenia. Second, automatic stabilisers, short-term anti-crisis measures, rescue packages to deleverage banks and enterprises, as well as greater debt servicing generated public deficits of circa 6 per cent of GDP annually between 2009 and 2012. Third, following the stress tests, the Slovenian banking system received a capital injection of 3.63 billion Euros in 2013 (IMAD 2014).

Table 2 Public finances as % of GDP (2000-13)

	2000	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Public revenues	42.8	43.4	43.6	43.0	42.2	42.2	42.3	43.6	43.5	44.4	44.7
Public spending	46.5	45.6	45.1	44.3	42.3	44.1	48.7	49.5	49.9	48.4	59.4
Budget balance	-3.7	-2.3	-1.5	-1.4	0.0	-1.9	-6.3	-5.9	-6.4	-4.0	-14.7
excluding one-off factors	-	-	-	-	-	-	-	-	-5.7	-3.8	-3.7
Gross public debt	26.3	27.3	26.7	26.4	23.0	22.1	35.2	38.7	47.1	54.4	71.7

Source: SI-STAT Data Portal.

Several observers have equalled the Slovenian crisis to that of Ireland or Spain, which suffered from housing bubbles.[iv] For two simple reasons, this narrative makes little sense. First, the largest construction companies, responsible for most NPLs, have themselves been the targets of over-leveraged MBOs (European Commission 2012, p. 19). Second, the concentration of bad loans in large domestic banks point to extensive governance problems, whereby credit with no or poor collateral has been extended without a proper risk assessment to all sectors, including construction (see IMF 2012, p. 1; OECD 2014, p. 44-50).

The reminder of this article identifies the causes for the Slovenian downfall. The ex-Yugoslav country inherited from socialism distorted lending and management practices of state-owned entities. Its protracted gradual transformation failed to uproot the cosy relationships between politicians, SOB directors and SOE managers, thereby locking the country in a *partial reform equilibrium* that required a trigger to be fully exploited. This came with the flood of cheap credit that accompanied the accession to the EU. State-owned banks extended massive loans to the corporate sector, without a proper risk assessment and backed by poor collateral, thereby fuelling several bubbles. These then engendered a banking-sovereign spiral similar to that of other peripheral Member States. Concomitantly, the exasperating political polarisation and conflict among the social partners that plagues Slovenia since 2004 prevented meaningful reforms to be legislated until it was too late. In 2011 the country slid into a *bad equilibrium* and still suffers from a severe debt overhang in the corporate sector and a huge reform backlog. The competitiveness of Slovenian enterprises, which was already declining as a consequence of the *partial reform equilibrium*, further deteriorated during the crisis, thereby holding up a healthy recovery.

3.1 The perils of protracted gradualism

Adam Przeworski (1991) has probably laid out the most persuasive argument in favour of gradualism. In his view, there is a trade-off between democratic processes and reform swiftness. As shock therapy imposes greater social costs onto the population, the losers of reform may halt the transitions from socialism to democracy, from central planning (or self-management) to a market economy, or both. However, several authors voiced reservation over this argument. Hellman (1998) warns against short-term winners that may capture the reform process; and even an ardent supporter of gradualism as Roland (2000, pp. 45-7) contends that correct sequencing is crucial. Reforms benefitting a minority of the (voting) population risk losing momentum vis-à-vis those producing benefits for the majority.

The experience of Slovenia corroborates these fears. Even though a gradual transition was initially beneficial, stretched in time it proved to be a double-edged sword. Rojec et al. (2004, p. 462) singled out the problem already in 2004: *"the transition in Slovenia has reached a point when persisting in gradualism generates more negative than positive results, i.e. that after the successful gradualist phase the country should step up the pace and replace gradualism with accelerated reforms. Persisting in gradualism may reduce the development capacity of society in the medium term. However, the gradualist approach has increased institutional rigidity and created a kind of political economic equilibrium which prevents a changeover to a more dynamic reform policy."* The authors agree with Hellman (1998) in stating that Slovenia entered a *partial reform equilibrium*, thereby entrenching special interest groups, which employ economic and political resources to win redistributive battles, instead of enhancing economic efficiency.

This *partial reform equilibrium* enabled the perpetuation of the lending and management practices, including a weak regulatory framework, inherited from socialism that underpinned the softness of the budget constraints of Slovenian enterprises. In practice, being part of a politically connected elite was a *condition sine qua non* to conduct business and to be awarded loans and subsidies without a proper risk assessment (see Damijan 2012b). Rojec et al. (2004, p. 477) enumerate the mechanisms through which gradualism maintained such status quo: a privatisation process, which did not generate an efficient ownership structure; state intervention in the economy through extensive state aid to the corporate sector; hesitant liberalisation, demonopolisation and privatisation in the financial and non-tradable sectors; costly prevention of Slovenian Tolar appreciation. Such mix enabled an inefficient service sector to thrive at the expense of restructuring in tradables; crowded out companies from the capital market, favouring banks and the state; erected barriers to entry by subsidising existing companies; restricted FDIs; made imports more expensive. What is most important here is that incomplete privatisation of state-owned enterprises and banks gave rise to the unsustainable lending practices to the corporate sector that ultimately brought the Slovenian economy to its knees.

The ownership transformation of ‘social property’ inherited from Yugoslavia in Slovenia is a drama in three acts. The first act took place during the Demos political interlude in 1990-92. Simoneti, Rojec and Gregorič (2004, pp. 229-30) explain that there were two approaches to privatisation: the Korže-Mencinger-Simoneti Act and the Sachs-Peterle-Umek Act. The former advocated decentralised, gradual and commercial privatisation, monitored by government; the latter relied on the rapid free distribution of enterprise shares through Privatisation Investment Funds (PIFs), centrally administered by the government. The controversy was chiefly political.

The advocates of decentralised privatisation argued that the socialist past should be exploited and not nullified, that Slovenia had a healthy economy, which required no shocks. Of course, such approach would favour existing managers and employees, affiliated to the left-liberal bloc. The supporters of centrally administered privatisation claimed that a clean slate approach would get rid of socialist legacies, empower the losers of transition and create Western-like ownership and corporate governance structures. This would benefit the new elites, i.e. the right-conservative bloc.

A stalemate ensued, and only in 1992 a compromise was reached with the Ownership Transformation Act: a mix of decentralised privatisation (through management and employee buyouts, MBOs and EBOs, distribution of shares to foreign owners, employees, creditors etc.) and free distribution of vouchers to satisfy the demand for equity (Mencinger 2004, pp. 76-78).

The final result was unspectacular. The law privatised only 68 per cent of social capital, whereas the rest (the best assets) stayed under (in)direct state control. The process lasted six years, generating inefficient buyouts, hybrid PIFs, and the quasi-governmental Capital Fund (KAD) and Restitution Fund (SOD). Simoneti, Rojec and Gregorič (2004, pp. 231-32) enumerate the ensuing corporate governance problems: low incentives to control management, conflicts of interest between inside and outside owners (present in most large enterprises), the deterrence to foreign ownership, failed transformation of PIFs, KAD and SOD into normal financial institutions that would be *"more interested in managing their portfolio of shares than in managing the companies in their portfolio"*.

The post-privatisation period was supposed to fix this. However, despite greater ownership concentration, the main problem of management unaccountability to outside owners or to the market persisted for three reasons: the largest shareholders do not hold majority (voting) control, quasi-governmental funds and PIFs became the largest shareholders in Slovenia, thereby providing ample opportunities for political interference, and among firms (mainly non-listed) owned by insiders the managers concentrated their stakes. Various economists estimate that the state retained control of roughly 50 per cent of the whole Slovenian economy (Damijan 2012b).

Last but not least, the lack of foreign competition became a feature of the Slovenian economy. Compared to the rest of CEE, the inward stock of FDIs in Slovenia was low: 22.4 per cent of GDP in 2004, against 50.2 in the Czech Republic, 60.4 in Hungary, 34.3 in Poland and 66.8 in Slovakia (UNCTAD data). Bohle and Greskovits (2012, pp. 202-11) correctly claim that Slovenian policymakers had a conscious strategy towards FDIs, prioritising national interest and, hence, domestic ownership (understandable after a millennium of foreign domination). FDIs were blocked in sensitive sectors (utilities, banking, infrastructure) and allowed only in technologically superior areas, thereby improving the country's export capacity. Even espousing this benign interpretation, it is plain that the Slovenian state retained excessive control over the economy, thereby delaying necessary restructuring that foreign owners might have undertaken.

In sum, during LDS's period in power, a number of insider-dominated oligopolies sprung up through mergers and acquisitions (M&As), trading with vouchers, but not via actual MBOs (a notable exception was the buyout of retail company BTC in 2001). Some 20 large financial holding companies emerged, whose managers were waiting for the right moment to appropriate the remaining assets that were still controlled by the state.

The second act concerned the financial service industry. The liberalisation and privatisation of banks was slow and the access to foreign competitors restricted (see Štiblar and Voljč 2004). Analogously, private insurance companies were cost inefficient as they lacked foreign competition and modern financial instruments. During the 1990s, according to Mramor and Jašovič (2004, p. 277), the *"opportunity for the capital market to play a central role in the Slovenian financial system [was] lost"*. So, Slovenia became a universal banking system based on indirect financing, where banks comprise more than three-quarters of financial assets of all financial intermediaries (more than 20 percentage points higher than the EU average). With a stock market relegated to a marginal role, loans became the primary source of financing and displayed shorter maturities than other financial instruments (capital and debt securities).

In order to improve the transparency of the Slovenian financial system, Premier Janez Drnovšek's government decided in 2001-02 to privatise through an international tender the two major state-owned banks (NLB and NKBM). In the name of national interest the sale of the financial institutions was discredited (see Ribnikar 2002) and then blocked (NKBM remained 100 per cent state-owned, while just 34 per cent of NLB was sold to the Belgian bank KBC).[v] Hence, Slovenia remained the only former socialist country with the majority of the banking sector under domestic state ownership, which suffered from severe corporate governance problems as well as was subject to continuous political interference.

The third act leading to the collapse started when Janez Janša's right-conservative executive took power in 2004. Even though it promised a radical, neoliberal turn for the Slovenian economy, the government knew that the existing *partial reform equilibrium* would have advantaged the right-conservative elites as well. In order to beef up its ranks, Janša's launched the so-called 'cadre tsunami',[vi] which replaced former leftist affiliates with own men in state-owned enterprises, funds, media and so on (some 3,000 estimated cadres). Mrvar and Žerdin (2007) provide a detailed picture and calculate that the circulation of the economic elite during the years 2004-6 was greater than during 1988-95.

One of the key proposals of the SDS government was to enact a 'transparent and gradual withdrawal of the state from the economy' through the conversion of SOD and KAD into normal portfolio investors, and the privatisation, open to foreign investors, of the largest SOBs, namely NLB and NKBM, of Telekom Slovenije as well as of the insurance company Zavarovalnica Triglav (Šušteršič, Damijan and Zajec Herceg 2006: 66-75).

Quite the opposite happened. In order to empower right-conservative elites, the new government launched a second privatisation wave (Stanojević 2014, p. 107). Thanks to the abundance of cheap money, neither maintaining state ownership nor selling to foreigner bidders was necessary. The SDS-led coalition actively collaborated in a number of acquisitions and MBOs by staging controlled sales of shares of SOEs, directly, to entrepreneurs affiliated to the right-conservative bloc, or in exchange for other assets, to existing managers. An emblematic case was the sale of the shares of Mercator, a retail chain, held by KAD and SOD in 2005 to Istrabenz, a holding company that originally dealt with energy, and Pivovarna Laško, a brewing company (Mekina 2007). The former was chaired by Igor Bavčar, a long-time friend and political collaborator of Janša, the latter by Boško Šrot, of the left-liberal camp. Šrot was given the possibility (and the credit) to acquire part of Mercator in exchange for influence on Delo, the largest Slovenian daily, which was at the time owned by Pivovarna Laško.

In conclusion, also during Janez Janša's rule, the *partial reform equilibrium* inherited from early transition has been maintained as it was instrumental both to co-opt the existing, entrenched elites that oligopolised the Slovenian economy during LDS's rule; and to empower the new ones, appointed by the right-conservative bloc.

3.2 Cheap credit and management buyouts

As explained in the previous paragraphs, the particularly inefficient privatisation process of the inherited Yugoslav 'social property' left the Slovenian economy with sizeable shares of state-owned enterprises and state-controlled financial institutions. Managers and bankers operated within a relatively stable *partial reform equilibrium*, which required a trigger to be fully exploited.

With the approaching EU and prospective EMU membership and, hence, with greater access to cheap credit, Slovenian banks started granting loans to the corporate sector, which were used for ownership consolidation rather than for restructuring.[vii] The favoured takeover method was the management buy-out, mainly performed by internal managers (as in the case of Merkur, a home-improvement business, and Bine Kordež), sometimes with the participation of external managers and employees (the cases of Iskra, electrical equipment, Autocommerce, a car retailer, or Viator & Vektor, transportation logistics).

Even though there are various ways to perform an MBO, possibly the simplest method is to first establish a shell company on behalf of the target firm's management. This then acquires a majority of the assets or equity of the target company and is in the end merged with it, so its debts get transferred to the target, which starts repaying them. What is more important for this paper is the way MBOs were financed.

The main instrument in Slovenia was the Lombard loan (Cekin.si 2009). Managers were granted credit by banks against pledged companies in the form of securities that can be readily marketable (stock), but also using real estate as collateral. The loans were easily granted and their duration extended for two reasons: the pledged companies were worth millions and during the post-accession boom their value was increasing. The problem of paying back interest was easily solved. The pledged company was either paying interest from its dividends or was itself extending loans to repay interest of other acquisitions, as it happened in the case of brewer Pivovarna Laško, acquired by Boško Šrot. Using this method, the MBOs simply pays for itself at the expense, however, of the restructuring and development of the acquired firms. The trick fails to work as soon as a company stops growing, which is exactly what happened at the onset of the Great Recession.

So, did anyone actually notice that Slovenian banks were taking on excessive risks? During Borut Pahor's left-liberal government (2008-11) an investigative commission, similar to that in Iceland, has been (half-heartedly) set up in order to investigate the responsibility for the buyouts. Even though Pahor's government stepped down before the commission completed its investigative activities, it published an interim report (Preiskovalna komisija 2011), thereby shedding light on weather legislative gaps and/or weak regulators helped exploiting the *partial reform equilibrium*.

With respect to legislation, it is not obvious that faulty laws enabled the MBOs (Preiskovalna komisija 2011; Damijan 2012a). The 1993 Companies Act (ZGD) already forbade a target company to assist financially the acquiring entity. Until 2004, there was not enough liquidity to perform large MBOs and when acquisitions started piling up, the 2006 Takeover Act (ZPre-1) imposed the requirement of a bank guarantee equal to the target company's value, i.e. a loan backed by collateral. Under normal circumstances these would have sufficed, but they were insufficient to face the systemic risk that was mounting. In fact, the loans extended by Slovenian banks were backed by the target companies' shares, whose price increased two- to threefold since 2004, grossly exaggerating their actual value.

Here is where political responsibility kicks in. For three years, just until the buyout spree was over, Janša did nothing to prevent the MBOs after cheap foreign credit flooded the Slovenian financial sector. Both the government and the Bank of Slovenia knew that systemic risk was growing. The new 2006 Banking Act (ZBan-1) would have required collateral worth 150 per cent of the target company's value to authorise a loan (still too little), but the implementation of this precise rule was postponed by one crucial year, from 2007 to 2008 (Damijan 2012a). Additionally, the Minister for the Economy Andrej Vizjak prepared the so-called 'anti-tycoon' legislation, i.e. the amendment to the Takeovers Act (ZPre-1A), which banned MBOs based on loans whose collateral are the shares of pledged companies, only in December 2007 (Dakić and Pušnik 2007). This happened roughly one month after Danilo Türk won the Presidential election against the former right-conservative first Slovenian Premier Lojze Peterle, when Janez Janša asked for and won a confidence vote in Parliament. Emboldened by the result, he inaugurated the pre-electoral period by starting an anti-tycoon war.

With respect to poor regulation, instead it is clear that the three agencies responsible for checking acquisitions, mergers and underlying loans – the Securities Market Agency (ATVP), the now renamed Competition Protection Office (UVK) and the Bank of Slovenia – failed in their supervisory tasks. The now disbanded investigative commission has not ascertained the exact repartition of responsibility. However, neither ATVP chief Damjan Žugelj, who claimed that the Agency just checked the formal takeover procedures and that the Bank of Slovenia was responsible for their content, nor former Governor Marko Kranjec, who argued that the Bank could not check all loan agreements, sounded very convincing. Let alone the UVK, which failed to condemn, for example, the acquisition of Pivovarna Union by Pivovarna Laško in 2005, which established a monopoly on the Slovenian market for beverages. In sum, Damijan (2012a) is probably right when stating that the responsibility for the Slovenian mess is easy to determine, but that there is no interest in doing so, as the main (political) actors would just *"bump into themselves"*.

In sum, Slovenia was left with an over-leveraged corporate sector that was totally unprepared to face the global financial crisis. As international orders dried up, firms were unable to repay their debts. While the banks started collecting the collateral, the Slovenian blue-chip index SBI TOP lost 66 per cent of its value in 2008 alone. Damijan (2014) calculates that by 2012, the total debt overhang (debt that has to be restructured) of the Slovenian corporate sector ranged between 27 and 36 per cent of GDP. Widespread bankruptcies left Slovenian banks with some 22 per cent of GDP worth of bad loans. Eurozone dynamics created the, now familiar, banking-sovereign spiral that pushed countries such as Ireland or Greece into the deepest recessions since the Second World War (see DeGrauwe and Ji 2013).

A quick glance at the Slovenian financial sector reveals the following situation. In November 2013, Slovenian banks held 44.9 billion Euros of classified claims, of which 7.8 billion are non-performing loans, more than 90 days in arrears, so, in clear default. Non-financial corporations and holding companies account for, respectively, 45.4 and 5.3 per cent of the claims and have credit risks incomparably higher than the household sector (Bank of Slovenia 2014, p. 28).

Table 3 shows that constructions as well as sectors, where major MBOs took place (trade, transport, financial intermediation and professional activities) are most exposed to NPLs. Large domestic banks (SOBs) not only hold the largest share of NPLs, but also have 54 per cent of claims unsecured and the rest covered by poor collateral, such as real estate that underwent various devaluations (Bank of Slovenia 2014, p. 37). By contrast, the problem for banks under majority foreign ownership is less acute.[viii]

Table 3 Classified claims and NPLs by bank group and by corporate sector (November 2013)

	Breakdown of classified claims against corporates, %				Proportion of arrears of more than 90 days in sector, %			
	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership
Agriculture, mining	1.3	1.2	2.1	1.3	15.6	22.5	16.2	2.6
Manufacturing	26.3	28.6	22.3	22.9	22.3	25.7	30.9	11.5
Electricity, gas, water	6.1	5.0	3.9	9.0	5.6	10.2	4.4	0.8
Construction	14.6	17.0	17.4	9.1	65.2	74.9	61.5	32.5
Wholesale and retail trade	17.7	15.4	20.9	21.1	24.4	32.9	18.3	14.4
Transportation and storage	9.8	10.0	2.1	11.5	11.0	13.1	33.1	6.2
Accommodation and food service activities	3.2	3.3	2.8	3.1	39.3	47.4	38.9	22.4
Information and communication	2.9	2.9	2.0	3.3	30.8	45.8	33.2	4.8
Financial and insurance activities	3.2	3.3	5.9	2.0	22.7	24.5	25.2	14.4
Real estate activities	4.8	4.4	6.9	4.9	26.8	33.8	29.7	13.4
Professional, scientific and technical activities	8.3	6.9	12.6	9.8	27.9	33.5	35.2	17.5
Public services	1.9	1.9	1.1	2.1	12.6	13.0	21.1	10.5
Overall	100.0	100.0	100.0	100.0	28	35.0	32.6	13.2
Total, million Euros	20,392	12,153	1,938	6,301	5,710	4,249	632	829

Source: Bank of Slovenia (2014. p. 35).

That the construction sector accounts for 1.9 out of the 5.7 billion Euros worth of NPLs attributable to corporates has misled many foreign observers to claim that Slovenia is just another Spain or Ireland, which suffered from a housing bust. A construction bubble has effectively mounted in the pre-crisis years in Slovenia. It was mainly fuelled by public infrastructure investment (highways). By 2008, gross fixed capital formation in construction amounted to 18.1 per cent of total gross VA, out of which the residential segment represented only 5.1 per cent (European Commission 2012, p. 16). As the winding-down of the highway programme and the crisis coincided, the collapse of the sector was the harshest in the EU: with respect to 2008, the value of all construction works during 2011 decreased by 51.2 per cent, the value of construction work on buildings by 59.8 per cent and on civil engineering projects by 45.0 per cent (Kastelic and Primožič 2012).

Notwithstanding, there are two reasons why the construction's sector crisis has to be assimilated to the rest of the narrative, being directly related to the *partial reform equilibrium* delineated above. First, the business model of construction companies gradually evolved towards investment in real estate development, which was in a time of growing housing prices more profitable than construction only. These companies started buying real estate that could generate prospective revenues (e.g. the shipyards in Izola, the housing complex Celovški dvori in Ljubljana, the tobacco company Tobačna Ljubljana etc.). In order to make these acquisitions, SOBs granted them loans backed by real estate collateral, whose value rapidly increased until 2008. The Great Recession sent house prices crashing down by some 29 per cent in inflation-adjusted terms until the end of 2013 (Matić 2012; European Commission 2014, pp. 16-17). Second, and most importantly, the largest construction companies in Slovenia (SCT Ljubljana, Vegrad Velenje, Primorje Ajdovščina, Cestno podjetje Maribor, Cestno podjetje Ljubljana and Kraški zidar), which account for almost half of the sector's debt (Bank of Slovenia 2014, p. 60), have themselves been the subject of over-leveraged MBOs. Hence, Slovenian banks faced losses both on operational lending to these firms and on the financing of their buyouts (European Commission 2012, p. 19).

Bank restructuring started only in December 2013 under the Government Measures to Strengthen Bank Stability Act. This envisaged the huge injections of taxpayer money to prevent the bankruptcy of the two largest banks, NLB and NKBM, and the transfer of their non-performing claims to the Bank Asset Management Company (BAMC) (see European Commission 2014, pp. 22-3).

3.3 Political polarisation and the exhaustion of neocorporatism

Beyond the banking and sovereign-debt crises, the main factor aggravating Slovenia’s decline is the policymakers’ delay in responding to the emergency. Political polarisation and the exacerbation of the conflict among social partners are both to blame for prolonged policy paralysis. Reforms have proven impossible to achieve at a time they were most needed. In particular, the necessary banking restructuring and fiscal consolidation were both delayed by at least four years.

On the political front, the ascendance of the right-conservative bloc to power in 2004 sounded the knell for Slovenian bi-partisan, consensual decision-making. Guardiancich (2012b) identifies three reasons for such development: increased ideological antagonism, polarisation and the end of broad coalitions.

Once the common goal of EU accession was achieved, the animosity between the left-liberal and right-conservative blocs exploded, leading to something similar to the Hungarian situation, aptly called by András Bozóki a ‘cold civil war’.

Polarisation increased dramatically. Due to dissatisfaction with the protracted rule of LDS, the difference in electoral support for the two blocs narrowed. In 2004, LDS and SDS obtained, respectively, 29.1 and 22.8 per cent of the vote (LDS lost almost 40 per cent of its electorate). More recently, the situation was even more balanced: SD in 2008 and Positive Slovenia (PS) in 2011, which garnered the support of LDS’s disgruntled electorate, beat SDS by a margin of less than 3 per cent of the vote.[ix]

Increased electoral competition also sanctioned the end to broad coalitions (a prominent feature of LDS rule). Neither Janša’s two right-conservative executives nor Pahor’s left-liberal government comprised any parties from the other camp, while Alenka Bratušek’s coalition included the Civic List, which defected from the right-conservative bloc. As an additional destabilising element, since 1997, the single-issue Democratic Party of Pensioners (DeSUS) has participated uninterruptedly to every executive (left and right) since 1997, preventing a thorough reform of the country’s pension system. These three factors increased the chances of alternation and policy reversals, and effectively prevent the forging of bi-partisan deals.

On the corporatist front, Stanojević (2012; 2014) explains why social dialogue weakened (perhaps irreversibly) during the accession process to the EMU. The system of 'competitive solidarity' was based on the unsustainable use of the inherited human capital. First, the labour market became dualised, pitching older core workers (highly protected) against new labour market entrants, thereby creating a generational divide. Schools and universities compensated for the lack of numerical flexibility in Slovenian enterprises by creating extremely flexible, unprotected 'student jobs'. Pahor's Minister for Development Mitja Gaspari noted in 2010 that (Gaspari 2010): *"The greatest informal economy in Slovenia is lawful, and this is student jobs."*

Second, in order to accommodate the external pressures of EMU accession, especially after the exchange rate was fixed in July 2006, the workforce was put under unprecedented strain and the traditional means for compensation were deemed insufficient (Stanojević 2014, p. 107). The workers demanded wage increases, became increasingly dissatisfied with union representatives and resorted to wildcat strikes even in successful companies, such as Gorenje (Stanojević 2009).

The unravelling of 'survival communities' coincided with a dramatic weakening of the social partners. Union density collapsed from 40.3 per cent in 2003 to 29.7 per cent in 2008 (Visser 2011). Unionisation declined in the manufacturing sector, and slightly increased among public employees. The main result was a radicalisation of unions' demands to retain their core membership. As for employer organisations, their encompassing character came under attack under the first SDS-led government. Membership of GZS became voluntary in 2006, so, the Chamber started recruiting private enterprises by espousing a much tougher pro-business stance.

Hence, the collapse of consensus building in the political and corporatist arenas coincided with the right-conservative bloc's electoral victory in 2004. Janša's coalition promised a clear break with the past (LDS was accused of clientelism and corruption) through a reform agenda that included the de-regulation of the labour market, the introduction of a flat tax and denationalisation. The neoliberal turn wrecked against the mass demonstrations of the unions (November 2005), which were excluded from decision-making for the first time in more than a decade. The government's popularity plunged and never recovered, despite its procyclical spending on expensive projects (such as the highway network) and an overall increase in public sector wages.

The following, centre-left government headed by Borut Pahor's Social Democrats was left with almost no room for manoeuvre when the Great Recession hit Slovenia. As international orders declined, bankruptcies and unemployment mounted. According to Stanojević (2014, p. 108) the major loser were the younger generations, as temporary forms of employment were hit hardest. By 2009, the country was shaken by wildcat strikes. Pahor's government responded with a number of short-term anti-crisis measures (reduced working time and temporary layoffs), which were still successfully concerted with the unions and employers. Faced with growing labour unrest, it recognised that the minimum wage was set too low. A wage hike became an unconditional request of ZSSS, and was accepted by the employers in exchange for the flexibilisation of employment contracts. The plan did not work out: Pahor gave in to the unions, but did not manage to construct the packaged deal demanded by GZS (Guardiancich 2012a).

The situation swiftly deteriorated. On the one hand, the employers started to boycott the ESS, ending 15 years of relatively peaceful social dialogue. On the other hand, Pahor underestimated the duration of the crisis and then hastily planned an overambitious structural reform package through the Slovenian Exit Strategy 2010-2013 (Mrak 2012). Mediation between the government, the entrenched trade unions, student organisations as well as the public sector over a number of measures, such as the regulation of student jobs or a relatively ambitious pension reform, proved impossible. Four referenda against their unilateral adoption – a last ditch attempt of Pahor's government – led to the abandonment of all structural reforms, deepened the political crisis and effectively pushed the country into a *bad equilibrium* (Stanovnik 2013).

Early general elections in December 2011 brought Janša back to power. His government focused on a third privatisation wave, presumably open to foreign investors, the banking system and the public deficit (Stanojević 2014, p. 108). After three years of budget overruns exceeding 6 per cent of GDP, the government announced harsh austerity measures. Despite massive strikes, it managed to negotiate a collective agreement with public sector employees, which cut their salary by 8 per cent, and a watered-down version of the previous executive's pension reform. By the end of 2012, civil society movements rocked Slovenia with mass protests against fiscal rigour and allegations of widespread corruption.[x] Janez Janša was removed from office by a constructive vote of no confidence in February 2013 (he currently sits in prison). He was replaced by Alenka Bratušek of Positive Slovenia, who herself resigned 15 months later after losing the leadership of her party against mayor Zoran Janković, himself a tycoon indicted for corruption and an ally of former President Kučan.

On the positive side, Bratušek's government sped up the pace of restructuring during 2013-14. It passed a labour market reform in March 2013 that increases flexibility and reduces segmentation. The Parliament endorsed the introduction of the balanced budget rule into the Constitution in May. In October new insolvency legislation was passed and by December banking restructuring started. Improved case management has enhanced judicial efficiency and a law establishing the Slovenian Sovereign Holding (SSH) was approved in March 2014, in order to consolidate the indirect ownership stakes of the state and facilitate the privatisation of non-core assets. On the negative side, there were notable delays and unpopular measures such as an increase in VAT. More efforts are needed to further rebalance the pension system, redraft the fiscal framework, regulate professions and student jobs, accelerate the privatisation of core SOEs, and revise minimum wages to regain the lost cost competitiveness. Banks still retain too many NPLs and corporate debt restructuring is at an early stage, so full recovery is yet to be achieved (Damijan 2014; European Commission 2014, p. 24).

Summing up, the number of failed reform attempts (the most spectacular being Pahor's) testifies to how the interaction between a divided political class and entrenched social partners is detrimental to finding rapid solutions within a polity accustomed to consensual and gradual institutional change. These failures to restructure were not reasons for the country's sudden collapse; however, they played a crucial role in exacerbating the effects of the Great Recession.

3.4 Deteriorating competitiveness and the debt overhang

Despite the effectiveness of 'competitive neocorporatism', which had generated sustained growth, Slovenian firms operated in a *partial reform equilibrium*, where poor corporate governance and ineffective regulation were the norm. Rojec et al. (2004, p. 464) documented the deterioration in Slovenian manufacturing exports to the EU vis-à-vis other CEE countries already in 2004. In particular, the composition of exports showed a languishing share of non-inferior intra-industry trade (that is, high-value-added high-tech manufacturing), thereby drawing attention to the long-term weaknesses of the Slovenian economy that were lowering the country's overall competitiveness. The authors impute the sluggish pace of economic restructuring to the, now familiar, failures of protracted gradualism: slow privatisation, excessive state intervention (subsidies and micromanagement), insufficient liberalisation, inefficient regulation of monopolies as well as the preservation of distortionary price-regulating methods.

This claim sits uneasily with most enthusiastic assessments of the Slovenian production regime. As illustration, despite a relatively high share of medium-high and high-tech production in manufacturing, the value added per employee in high-tech has fluctuated between 55.6 and 60.8 per cent of the European average in 2003-08, and declined during the crisis to less than 60 per cent. This means that the Slovenian situation is not dissimilar to that of most other New Member States, implying that mostly labour-intensive segments of value added generation are carried out in manufacturing (IMAD 2011, p. 21; 2013, p. 27).[xi] The difference with other NMS is that unlike in Slovenia, the value added per employee increased substantially during the period preceding the crisis (2003-08), albeit starting from a lower initial level (reliable data are scarce): by 13.9 percentage points in the Czech Republic, 7.5 in Hungary, 30.8 in Lithuania and 19.2 in Slovakia.

As the crisis hit, the situation did not improve. In 2008-11, Slovenia lost 15.9 per cent of its world merchandise market share and 6.7 per cent with its most important trade partners. After that, whereas Slovenian exports, the main driver of a small open economy, grew slower than the recovery in global trade, the Visegrád countries have all performed better (European Commission 2014, pp. 29-31). Excessive indebtedness and lower cost competitiveness precipitated Slovenian firms from a *partial reform equilibrium* that was artificially propped by the global boom, into a *bad equilibrium*, from which they can escape only through governmental intervention.

According to Damijan (2014), up to 13 out of 23 thousand Slovenian companies face an unsustainable debt burden. Six industries (manufacturing, construction, wholesale and retail trade, transportation and storage, real estate, professional, scientific and technical activities) hold most of the excessive debt, which is highly concentrated: the 300 top debtor companies account for 70 per cent of the total debt overhang. The share of non-viable companies that should face bankruptcy is huge: 13.7 per cent or 3,175 firms, which represent 13.0 per cent of Slovenian value added, 14.4 per cent of employment and 7.1 per cent of exports. Of these, nine are too big to fail – five state-owned companies in public utilities (highways, rail, electricity) and four companies that were subject to buyouts, that is, Mercator and Merkur (wholesale and retail trade), Pivovarna Laško (food industry), and Cimos (automotive industry) – which again shows the softness of budget constraints in Slovenia and the damage inflicted through leveraged MBOs. Moreover, lack of firm financial soundness became a critical factor constraining firm performance during the crisis (Damijan 2014). High leverage and the ability to service the outstanding debt inhibit productivity growth and reduce exports, employment and investment. Small and medium enterprises fare here worse as they have a weaker position when renegotiating their debts.

Deterioration in Slovenian cost competitiveness went hand-in-hand with lower productivity. Compensation per employee increased substantially in 2008, following wage adjustment for high past inflation and productivity in the private sector, and due to the Virant reform, called after Janša's Minister of Public Administration Gregor Virant, that equalised wages (upwards) in the public sector (IMAD 2011, p. 90). Additionally, in 2010, the Pahor government introduced a major, 23 per cent hike in minimum wages, which was only partly offset by a freeze in indexation elsewhere. Increasing unit labour costs grew out of line with labour productivity and the real effective exchange rate (REER) has deteriorated vis-à-vis the Eurozone, mainly due to the short-term anti-crisis measures, which encouraged wage inertia and labour hoarding (European Commission 2014, pp. 29-30).

In order to hasten the recovery, the twin problems of indebtedness and cost competitiveness require a comprehensive governmental plan. The exit of non-viable firms should be facilitated through smoother bankruptcy and insolvency procedures, viable firms need thorough debt restructuring and labour costs have to be brought in line with productivity through lower labour taxation, diversified minimum wages and reformed public salaries. The reduction of the state's share in all branches of the economy is a final *conditio sine qua non* (see Georgieva and Riquelme 2013).

4 Conclusions

This article individuated the main reason behind Slovenia's decline from post-socialist frontrunner to sick man of Europe: a protracted gradualist approach that never rectified an inefficient privatisation process, Slovenia's original sin. This locked the country into a *partial reform equilibrium*, where economic elites – the short-term winners – were extracting rents. The flood of cheap credit, following the accession to the EU, as well as the gridlock in policymaking pushed the country into an economic and political *bad equilibrium*, whose consequences are felt almost seven years into the Great Recession. Despite a relative ease of the financial markets' grip over the tiny ex-Yugoslav republic, the economic and political challenges ahead are as formidable as ever.

If debt restructuring and recovery in competitiveness are foremost to bring the economy back into shape, it is the political system that failed in its tasks for almost a decade. Even though an international bailout has been for now avoided, the country is *de facto* applying an externally dictated rescue-cum-retrenchment package, which often undermined the input and output legitimacy of the governments that received them (Scharpf 2011). Notwithstanding, the successful and autonomous disentanglement from the crisis is crucial to regain public confidence and trust in national institutions, which is, according to Niko Toš of Politbarometer, at its lowest in Slovenian history.

Commenting on the perils of protracted gradualism, back in 2004, Rojec et al. (2004: 62) hoped that *"[…] a shift [to a more dynamic reform policy] is only possible if assisted by an exogenous shock, for example accession to the EU and meeting of the related economic criteria. With the threat of negative external shocks, it shortens the period available for reforms to such an extent that gradualism ceases to be a feasible economic policy strategy."* This did not happen, as most reforms have not been carried out during the ten years following the accession. Instead, it took the Global Recession to trigger a comprehensive reform effort in Slovenia, which in the best-case scenario, that is, if it does not derail from its tracks, will bring more social and economic pain than an even slightly more timely intervention.

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[i] For a detailed account, see Åslund (2012: Chapter 2).

[ii] Rojec et al. (2004, p. 461) use EBRD's transition index to show that Slovenia consistently lagged by a year or two behind the highest ranking of the eight New Member States (NMS) in its reform efforts.

[iii] According to Fink-Hafner (2006), European integration enjoyed a similar status as independence from Yugoslavia, spurring intense cooperation across ideological divides.

[iv] See, for example Quartz (http://qz.com/81836/slovenia-crisis-bailout-debt/) or TroikaWatch (http://www.troikawatch.net/the-slovenian-banking-and-debt-crisis/).

[v] According to economist Jože P. Damijan (2007), who most closely studied the ownership transformation process in Slovenia, the managing elite opposed the privatisation of Slovenian banks through the powerful lobby Forum 21 (headed by former President Milan Kučan).

[vi] The term 'cadre tsunami' was coined in February 2005 by opposition MP Slavko Gaber of LDS.

[vii] Former governor Marko Kranjec stated that by end 2007, at least 2.6 billion Euros (some 7.5 per cent of GDP) of claims concerned MBOs by the end of 2007. However, the exact amount of loans granted for that purpose is unknown, as the Bank of Slovenia does not count them separately (Preiskovalna komisija 2011, p. 42).

[viii] Even though elsewhere this was no guarantee for integrity, in Slovenia, a number of foreign-owned banks, such as SKB (Société Générale) and Banka Koper (Intesa Sanpaolo) have fared better and have not undergone any stress tests. According to the President of the Board of Directors of SKB Cvetka Selšek (2013), foreign-owned banks had stricter codes of practice, and extended fewer loans to businesses engaged in speculation. The results of the stress tests for Slovenian non-state-owned banks reinforce the claim.

[ix] During the shambolic post-electoral negotiations at the end of 2011, Positive Slovenia, led by mayor of Ljubljana Zoran Janković, did not manage to secure a majority, de facto handing in the government to Janša's SDS.

[x] Damijan (2013) speculates that the very managers responsible for the MBOs tried to bring Janša down, also by sponsoring the anti-government demonstrations. The main reason would have been the government's decision to establish a 'bad bank' (the current BAMC) that would basically appropriate (i.e. re-nationalise) those shares for which loans could not be repaid and sell them (i.e. re-privatise) on the market. This would be a deathblow for the tycoons, who hoped for a general reprogramming of their loans. Incidentally this was the path undertaken under Pahor's government, which shunned the possibility

of establishing a 'bad bank'. Under Janša such solution was heavily ostracised in Parliament, until it became unavoidable after the stress tests exposed the extent of the rot.

[xi] As example, the now bankrupted Prevent Global was a leader in the Slovenian automotive industry, but its production was chiefly labour-intensive as it supplied seat covers for car giants Audi, BMW, Citroën, Ford, Mercedes, Porsche, Renault, Volvo and VW.