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After 20 Years of Status Quo: The Failure of Gradualism in Slovenia's Post-Socialist Transition

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Abstract

In the past 20 years, the Slovenia has been praised as the richest former socialist country, having accomplished the advancement from borrower into donor status at the World Bank and having entered the European Monetary Union as the first country from former socialist block. In the due course of transition to market, Slovenia adopted the gradualist approach to economic reform, emphasizing gradual privatization, excessive regulation of the labor market and financial sector as well as the slow stabilization of public finances. In this paper, we review macroeconomic performance of Slovenia in past two decades in a comparative perspective. The paper outlines the growth trajectory of Slovenia from the onset of Habsburg Empire to the present. We showed that until 1939, Slovenia has almost fully converged to the income per capita frontier of Austria and Italy while the income per capita diverged substantially in the period 1945-1990 from Western European frontier. We review the contours of labor market protectionism, state dominance in banking and financial sector and emergence of the corporate oligarchy as the main symptoms of stalled economic performance given a substantial differential in income per capita between Slovenia and EU15. Moreover, we demonstrate how former communist elites transformed into powerful networks of interest groups which preserved status quo from socialist period through systemic blockade of key economic reforms to stabilize public finances in the light of age-related pressures and to boost productivity growth and structural change.

JEL Classification: E02, N13, N14, P16, P27,
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I. Introduction

2011 year marked the twentieth anniversary of political independence in Slovenia. It was a momentous date, marking the longest period of state independence since the country ceded from the former socialist Yugoslavia in 1991. After twenty years of political independence, it is essential to examine the country's economic progress in more depth.

In the last two decades, Slovenia has often been represented in the international media as the most successful ex-communist state, having accomplished Euro-Atlantic integration as well as being the first former socialist bloc country to enter the Eurozone. The consequence of judging the country's economic performance on a purely comparative basis has been to neglect the deeper analysis of long-term macroeconomic patterns and determinants of growth. Four decades of flawed Marxist economics have produced distorted economic assumptions, and led to a significant divergence from academic developments in the Anglo-Saxon world. This has resulted in a virtually non-existent understanding of Slovenia's past economic development.

II. Macroeconomic History in a Nutshell

It is often presumed that Slovenia had a poor economic performance before joining the socialist Yugoslavia, as measured by income per capita. Yet evidence from the Habsburg Empire (Good, 1994) suggests, via quantitative indices, that differences in terms of income per capita can be noted between different Slovenian regions. These estimates suggest that in 1913 regions such as Littoral, Carinthia and Styria sustained comparatively high levels of income per capita, comparable to that of Imperial Austria, whilst Carniola continually experienced low income per capita and a low rate of growth prior to World War 1. In 1913, the Littoral region (Gorizia, Gradiska, Trieste and parts of Istria) enjoyed the sixth-highest income per capita in Imperial Austria. At this time the level of nominal wages in Trieste had also converged to the Prague level.

The emergence of the first Yugoslav state, renamed the Kingdom of Yugoslavia in 1929, was accompanied by divergent levels of income per capita across the country's different regions. Although the Kingdom of Yugoslavia established national income accounts in 1938, estimates by Broadberry & Klein (2008) suggest that by 1937 Yugoslavia experienced one of the lowest levels of GDP per capita in Europe. In terms of constant 1990 international dollars, it was one of Europe's most underdeveloped countries in 1938. An observation by the Library of Congress (1992) described pre-war Yugoslavia as a country of stark economic divergence; between the highly-developed North and the less-developed Southern regions. In 1937

Yugoslav income per capita was 30 percent below the world average, whilst the eradication of feudalism left 75 percent of the population below the official poverty line. Slovenia however enjoyed a substantial advantage in terms of income per capita relative to other parts of the Kingdom. Ljubo Sirc has convincingly argued that by 1939 the level of real wages in Slovenia had been steadily converging to the Austrian level. The empirical regularities of income per capita patterns suggest an unequivocal convergence to the steady state. If Slovenia enjoyed income per capita 100 percent above Yugoslav average, then in 1937 the level of income per capita in Slovenia represented 78 percent of the Austrian level in the same year. It can thus be seen that the adoption of the socialist economic model led to a disastrous economic outcome.

In 1950, the level of income per capita dropped to 34 percent of the Austrian level and remained intact ever since. One could not describe the Yugoslav miracle (Sapir, 1986) in the late 1960s and early 1970s as a period of sustained growth, since the engine of growth did not incorporate technological change and steady productivity gains. Instead it was symptomatic of capital deepening based on foreign aid and credit-fuelled expansion amid rachitic productivity growth. From 1960 to 1975 Yugoslavia's annual average growth rate was 5.42 percent, whilst from 1975 to 1989 the annual rate of growth declined to 1.04 percent; one of the lowest in developing countries (Rodrik, 1998). The foregone experience of hyperinflation and the consequent collapse of the Yugoslav communist economic model resulted in a significant cumulative output decline during the transition from socialism to a market economy.

III. Unpleasant Growth Arithmetic

The evidence suggests that the socialist period was detrimental to the long-term rate of productivity growth. This arose from the distortion of incentives inherent to the socialist economic system. From 1972 to 1980, Slovenia's annual rate of economic growth tottered below the average of high-income socialist countries. The Czech Republic, Estonia and Poland grew at a far higher annual rate, revealing a pattern in income per capita convergence; even though the difference in the level of output per capita remained significant throughout the period. At this time output grew by 2.14 percent annually; far below the rate of growth in neighboring Austria (3.4 percent) and Italy (3.32 percent) during the same period.[1] This caused the divergence in per capita income, which occurred despite a substantially higher investment-to-GDP ratio. This translated into capital deepening without efficiency

[1] The estimates of long-run growth rates are based on International Macroeconomic Data Set, provided by U.S. Department of Agriculture:
http://www.ers.usda.gov/Data/Macroeconomics/#HistoricalMacroTables

gains, whilst the growth of total factor productivity stalled. As Figure 1 succinctly suggests, the level of real income per capita in Slovenia had stalled relative to the EU15 during the socialist period and did not grow significantly faster than the EU15 average throughout the post-socialist transition to signal permanent and robust cross-country convergence.

Figure 1 [Near here]

It is telling to compare this case with those of Slovenia and Malta, demonstrated in Figure 2. In 1950 Malta was one of the most impoverished countries in Southern Europe[2] - falling behind even Bulgaria - whilst Slovenia enjoyed the highest income-per-capita level in Central Europe. However from 1960 to 1975 and in 1989, Malta sustained a 5.9 percent average rate of economic growth, which meant that it took 12 years for income per capita to double; whilst Slovenia's average rate of growth meant that it took 30 years for income per capita to double. In 1991, both countries enjoyed the same per capita income.

Figure 2 [Near here]

The failure to boost the long-term rate of economic growth is key to understanding the narrowing gap in income per capita between Slovenia and other transition countries. For instance, Slovakia's lower initial per capita income in 1991 would imply that in the long run the country will grow one percentage point faster than Slovenia on a permanent basis. In 1991, therefore, Slovenia enjoyed 64 years of time-distance advantage ahead of Slovakia. Annual rate of growth estimates by the IMF (World Economic Outlook, 2011) suggest that in the short term Slovakia is set to grow by 2 percentage points faster than Slovenia. Hence the difference in the time to catch up would narrow to 26 years respectively. Differences in per capita income can ultimately be explained by differences in the institutional setup and the nature of public policy. Transition growth figures (Summers & Heston, 2007; Economic Research Service, 2010) suggest that long-term rates of growth are systematically higher in countries that have adopted shock therapy (Czech Republic, Poland) than those which followed the gradualist approach to economic reform (Hungary, Slovenia). Countries that adopted shock therapy have also weathered the financial crisis better than gradualist countries; emphasizing the strength of a liberalized financial sector and the flexibility of labour markets in overcoming adverse economic downturns.

[2] Apostolides (2008) estimated the average GDP per capita growth rate for Malta during the interwar period (1921-1938) at 0.5-1.5 percent which characterized the country as the slowest-growing Southern European country prior to World War 2.

IV. The Rise of Gradualism

Critiques of curvature in post-socialist transition over the last two decades have often been accompanied by rigorous and nonchalant attacks from the intellectual fathers of Slovenian transition. After ceding from Yugoslavia, Slovenia pursued a rigorously gradualist approach to transition. Macroeconomic indicators suggested a continuous output decline and hyperinflation; inherited from the Yugoslav era. One account by the European Bank for Reconstruction and Development (EBRD) suggests that Slovenia suffered the largest cumulative output decline amongst high-income transition countries (Slovenia, Czech Republic, Slovakia, Hungary and Poland), despite having adopted a gradualist approach to economic reform; in an attempt to absorb the institutional shock that precipitated the early stage of transition. The ultimate decision to pursue gradualism rested mainly on the assumption that the composition of trade flows and enterprise restructuring would decrease in magnitude over time.

The proposal by Jeffrey Sachs (Sachs & Pleskovic, 1994) to launch rapid privatization led to a significant disruption for post-communist nomenclature which favoured mass-privatization based on dispersed ownership – stemming from the premise that such an initiative would limit foreign direct investment. Early transition reinforced the mirage that social ownership could be efficient. The losses of the corporate and banking sector were facilitated by soft budget constraints that further delayed enterprise restructuring; the essential measure of maturity from post-socialist transition. A study by prominent authors (Pohl et. al, 1997) examined evidence from Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia - during the period 1992-1995 - to determine which economic policies were most conducive to enterprise restructuring. The evidence overwhelmingly suggests that rapid privatization - based on concentrated rather than dispersed ownership, and with hard budget constraints and restrained wage increases - is the best facilitator of enterprise restructuring. The Slovenian episode of privatization, which was based on dispersed ownership and the sale of assets by special investment funds, eventually became subject to a typical example of capture by insider-owners, who took an informational advantage by inflationary loans. This later became an insider-information spiral, where insiders gained considerable ownership premium at the expense of external shareholders, who suffered from a poor level of protection.

The consequences of privatizing state-owned companies on an ‘insider’ basis proved disastrous when judging both the dynamics and the progress of enterprise restructuring. The evidence (Transition Report, 1998) suggests that by 1998 the Slovenian private sector was marked as having the lowest share in GDP amongst Central European states, constituting just 50 percent of the total, compared to 75 percent in the Czech Republic and Slovakia. The fragility of the private sector gradually evolved into a rigid business environment and a sustained lack of incentives to instigate full enterprise restructuring. Moreover, the EBRD estimated that enterprise restructuring had stalled since the late 1990s - an estimation which was confirmed during the recent financial crisis when state-owned companies with poor corporate governance and insufficient restructuring were particularly affected/hit.

The 2008/2009 financial crisis was no panacea to the fragile banking sector. The privatization of Nova Ljubljanska Banka (NLB), Slovenia's biggest bank, had stalled several times. This had occurred despite the fact that stress-tests had clearly suggested that the bank would not be able to withstand a bold systemic liquidity shock, given an over-leveraged balance sheet. Since the crisis, NLB losses have further been cushioned by continuous budgetary recapitalizations which have acted as a classic bailout mechanism. This suggests that the bank's overall portfolio suffers heavily from a myriad of bad loans – a suggestion recently affirmed by the Moody rating agency, which further lowered the bank's overall credit rating.

The Government owns two-thirds of banking sector assets, including the three-largest banks. A concerted effort to boost far-reaching privatization and systematic restructuring has failed, mostly because of the pervasive influence of a network of former-communist politicians and businessmen. They favour direct influence in capturing the banking sector so as to establish and secure favourable lending relationships. So far, the absence of a privatization mechanism has produced a weak and unaccountable banking sector. This encouraged the high quantity of direct loans for corporate takeovers prior to the crisis, which ignored corporate finance fundamentals and later triggered the collapse of the SBI20 stock market, - the most dramatic collapse of any stock market index in the history of advanced economies. The only viable option to liberalize the banking sector would be to enact a rigorous privatization of the state-owned banking sector to foreign institutional investors. The degree of systemic and hidden corruption in the Slovenian financial sector is so high, that privatization to domestic owners would not resolve the inefficiencies produced by twenty years of state ownership.

V. Corruption, Judiciary and the Oligarchs

Although Slovenia's ranking has significantly improved on Transparency International's Corruption Perception Index, the degree of hidden corruption is perceived as/understood to be significant and persistent. The rise of oligarchs, who have exacerbated state capture, allowing for corporate takeovers and the dismissal of regulatory authorities, is attributed above all to systemic corruption arising from influence. Administrative corruption, which is difficult to distinguish and ascertain as an empirical regularity, is assigned a minor role (Hellman, Jones and Kaufmann, 2000). As Slovenia embarked on its gradualist approach to economic reform, former communist elites were given space/time to transform into a powerful network of politicians, civil servants and businessmen - a network accustomed to a predatory form of capitalism, shaped by the distorted moral foundations of communist ideology.

Regulatory authorities and judiciaries were hindered from investigating and acting upon these attempts at state capture due to the lack of an independent judiciary. Such independence is defined as a separation from political influence, but it also includes an adherence to the principles of liberal democracy (such as the rule of law), adherence to contract enforcement and adherence to the principles of fairness in judicial trial. Consequently, the fragility of rule-of-law institutions in Slovenia increased the demand for public regulation, as a mechanism against social inequities arising from the redistribution of resources through rent-seeking and other unproductive (Alesina & Rodrik, 1994: Alesina & Angeletos, 2005; Murphy, et. al., 1993). The evidence overwhelmingly suggests that social distrust creates public demand for higher regulation, which further discourages the formation of social trust (Aghion et. al, 2008). In 1994, when Index of Economic Freedom released its annual report, Slovenia enjoyed the lowest and least stable functioning judicial system in Central Europe. In Figure 3, it can be seen that the level of economic freedom in Slovenia remained repeatedly low compared to other countries. The fact that the level of economic freedom in less-developed countries such as Rwanda, Cape Verde and Kazakhstan is perhaps the most compelling evidence suggesting that the socialist economic legacy with poor contract enforcement, inefficient public sector and endemic corruption has not been effectively dismantled at all.

Figure 3 [Near here]

One could trace the relative malfunctioning of the Slovenian judicial system to its legal origins. Recent studies (La Porta et. al. 2008) overwhelmingly suggest that countries with a civil law system suffer from lower economic outcomes than those with a common-law equivalent. But in our example, this particular notion fails to explain why post-socialist countries – who adhere to the latter yet fail to incorporate principles of substantive justice –, have performed poorly in comparison to countries with German, civil-law, legal origins. These civil-law countries have generally managed to at least ensure the continuity and stable functioning of the rule of law. The failure of the judicial system to adhere to these principles in post-socialist states has been caused mainly by the complete absence of lustration, which could expel former communist officials from chairmanships in public institutions – as occurred in the Czech Republic in the early 1990s.

The very absence of effective contract enforcement allowed for various regulatory shortcomings, emerging from the fact that basic enforcement mechanisms were governed by the influence of post-communist networks, and not by independent legal principles. This influence extended beyond the scope of state administration, and began to also affect institutions in the conduct of private affairs.

One example of this is the sustained influence of the former nomenclature in higher academia. This monopolisation worked to stifle the implementation of new ideas and policies. In various discussions and debates, the academic nomenclature has dismissed new proposals - such as labour market liberalization, openness to foreign direct investment and a flat-rate income tax - as being flawed, dangerous or primitive. The perils of the economic nationalism which facilitated the rise of the corporate oligarchy were considered almost non-existent and were, by and large, ignored. Left-leaning media, oligarchic businessmen, nationalist politicians and (in)dependent academia argued forcefully for abandoning proposals of lower tax rates, privatization and labour market liberalization. In various public policy discussions, the intellectual architects of gradualism proved themselves ignorant of the consequences of economic nationalism.

The early warnings of stock market fragility, occurring in the aftermath of the 1989 euphoria, were blissfully ignored - despite the fact that the Slovenian stock market echoed a similar pattern of volatility to China. In spite of the buoyant growth of the stock market - fuelling significant asset-price inflation - the stock market for major state-owned companies experienced a significant drive from fundamentals. Price-earnings ratios were surpassing net dividend yields considerably, suggesting a significant spike in insider-information trading, which leaves the shareholder to bear all the cost, and encourages insiders to take greater and greater risks. Eventually, the collapse of the SBITOP, the Slovenian blue-chip market, demonstrated the pitfalls of economic nationalism –a policy which had worked to boost oligarchic entrepreneurship by means of powerful nomenclature networks aided by academia, the media and short-sighted policies. Gradually, Slovenia began to witness the emergence of a Russian-style oligarchy which accumulated an enormous wealth through political channels. It did so by violating the rules of the game and overriding sound corporate governance principles. At the same time it amassed political power, ultimately facilitating state capture in the early stage of transition. Therefore, the Slovenian version of gradualism could be labeled as maintenance of the status quo, since key areas of economic reform - such as privitisation, competition policy, and the restructuring of enterprises - remained virtually intact.

VI. Sclerosis of the Labour Market

The evolution of the labour market in the early stages of transition was facilitated by a set of structural shocks that led to a downward adjustment in real wages. The labour market of the late 1980s and early 1990s was characterized by declining labour productivity and declining output per capita. It is nonetheless essential to underline the structural characteristics of the post-socialist labour market. As Woodward (1995) suggested, reported rates of unemployment in socialist Yugoslavia differed markedly from actual unemployment rates. Latent unemployment was a characteristic of the labour market in Slovenia at the onset of transition to a market economy. After the disintegration of Yugoslavia, the labour market suffered from a chronic lack of productive capacity, which reflected low actual comparative rates of human capital investment in a socialist economy. Therefore, Slovenia's entry into post-socialist transition was earmarked by an excessive labour capacity that could not solve the problem of persistent latent unemployment. Excessive labour capacity stemmed generally from low levels of human capital, but particularly from the trade disintegration which followed cessation from the Yugoslav federation. The Slovenian manufacturing sector suffered chronically after this event.

The absence of large-scale enterprise restructuring complemented rising labour market rigidity, which was characterized by increased trade union power. This effectively prevented productivity improvements at the firm level by shielding workers in both private and public sectors from competitive pressure to relocate talent into more productive uses and to facilitate human capital investment. Lack of enterprise restructuring had effectively acted as a substitute for efficiency gains from human capital investment. If human capital investment (Acemoglu, 1995) is not provided as an impetus for labour market transformation, excess labour capacity, an inherent characteristic of socialist unemployment, is channeled through higher rates of unemployment. Trade unions, once the hallmark of the socialist economy, have swiftly established an extremely rigid system of labour market institutions by establishing collective bargaining schemes as the means of avoiding the facilitation of productivity improvements through human capital investment.

The architects of gradualism had not envisaged the transformation of the labour market at all. The rigidity of the labour market mechanism, measured by the regulation of hiring and firing and the magnitude of labour cost per effective unit of output, acted merely as a substitute for comprehensive restructuring and hindered the necessary relocations of talent, skill and human capital investment.

The notion of labour market liberalization originally proposed by Jeffrey Sachs in 1994 was dismissed not only by the media but also by politicians and trade union leaders who emphasized temporary job security concerns in the early stage of transition. But, as Milton Friedman once brilliantly noted, nothing is as permanent as a temporary government programme. In the early years of transition, the labour market did not gradually evolve into a mechanism for the reallocation of talent and human capital, but into an unhealthy system of job security. This was especially so for public-sector workers where dismissals have been impossible to enforce, therefore emanating in a deadweight loss, compensated by an increase in the share of government spending as a proportion of total GDP.

In 1992, the rate of real wages for civil servants and public sector employees grew considerably. By 1995, government spending as a share of GDP had increased from 41.1 percent in 1991 to 54 percent. The rise of real wages for civil servants has been problematic mostly because the adjustment of real wages has not been linked to the short-term rate of productivity growth; exacerbating significant pressure on labour costs and, hence, the annual rate of inflation. The boons of public sector employment naturally resulted in the diversion of labour resources from the private to the public sector. It should not be concluded that the private sector's labour market is unaffected by corruption, rigidity and shortcomings of unadjusted wage determination however, since these characteristics are intrinsic to the labour market in contemporary Slovenia.

A highly rigid labour market, plagued by union intervention in the determination of wages and labour contracts, is highly susceptible to moral hazard; since unionised workers enjoy considerable wage premiums, yet also create a deadweight loss from a rigid labour supply. In the case of the public sector, this is borne by taxpayers. The empirical evidence (Mattina & Gunnarsson, 2007) suggests that despite substantially high earnings for public sector workers, the public sector suffers from low expenditure efficiency, particularly in health care, education and social protection:

> "Spending on health care, education, and social protection is relatively high in Slovenia without achieving correspondingly better outcomes. Inefficiencies appear to stem from the financing mechanisms for social services, institutional arrangements, and the weak targeting of social benefits. In addition, the composition of spending appears to be strongly tilted towards nondiscretionary items that reduce the fiscal room for maneuver. Greater flexibility is needed to facilitate the reallocation of relatively inefficient expenditure into higher priorities.

In this manner, medium-term expenditure rationalization can focus on reducing inefficient outlays rather than restraining traditionally flexible components of the budget, such as public investment."

The most formative characteristic of the post-socialist labour market in Slovenia is a benign productivity growth which remained inherent to the structure of the labour market. Throughout the transition, the gains from rising productivity have been modest. Figure 4 demonstrates that throughout the transition period, the growth of labour productivity, ultimately driving the level of income per capita, has been characterised by slow growth and yet substantial gap between Slovenia and EU15. In 2006, the level of labour productivity has not increased at all. Moreover, from 2006 to 2010, the level of labour productivity deteriorated from 83.1 percent of the EU average to 81.6 percent. The convergence of productivity took a full-fledged course within the EU. Unfortunately, the level of productivity in Slovenia has converged by very little to the frontier of high-income countries in the EU. On the other hand, countries that enforced shock therapy and growth-oriented policies such as Poland, Czech Republic and Slovakia have experienced a steady convergence of labour productivity to the high-income frontier, although the difference is still substantial. However, high-income transition countries (Poland, Czech Republic, Slovakia) have increased their productivity levels substantially relative to Slovenia. In 1991, Slovenia sustained two-thirds of the EU productivity level whilst Slovakia's productivity level represented half the level of the EU average. As mentioned above, productivity growth in Slovenia has stalled since 2006 whilst Slovakia has experienced brisk productivity growth. In 2010, Slovakia's level of labour productivity represented 82.6 percent of the EU average whilst Slovenia achieved about 81.9 percent of the EU average. This clearly demonstrates the benefits of growth-oriented policies pursued in Slovakia since 2000, and the pitfalls of consensus-based economic policies which are characterised by high taxation, rigid labour markets and a state-dominated financial sector.

Figure 4 [Near here]

Whilst Slovakia has begun to reform its taxation system, privatise its state-owned industries and liberalise its financial sector, Slovenian policymakers have merely revived the old notions of social justice as a way to maintain the status quo. This has yielded immense political rents by favouring particular interest groups (Mrkaic & Pezdir, 2007) in the labour market. Yet rent-seeking without system-wide productivity growth has resulted in productivity stagnation to such a degree that Slovenia can no longer boast the highest productivity level amongst other post-socialist states.

VII. State Capture of Public Finance

The transition to political independence was marked by acute problems of poor infrastructure and low-efficiency labour, which required systemic restructuring. Yet the extensive latent unemployment rate ultimately translated into significant structural unemployment. Uniquely, policymakers chose to address persistent structural unemployment by altering the parameters of the public pension system. In particular, economic policy chose to follow the gradualist prescription by lowering the effective age of retirement to very low levels, enabling the structurally unemployed to avert human capital investment in the labour market and enter retirement. Although lowering the effective retirement age to a level below actuarially justified levels proved a popular political measure, it posed a significant threat to the long-term stability of public finance, which gradualism had simply overlooked.

The impact of macroeconomic disequilibrium was immediate. From 1990 to 1995, the level of government spending increased to over 54 percent of GDP. Spending on the elderly also grew significantly. The divergence of old-age spending from actuarially-fair levels and the subsidization of early-retirement has placed an irreversible burden on the stability of long-term public finance. In the last two decades, when economic policymakers became aware of the consequences of these transitional retirement policies, any attempt to increase the effective age of retirement has been hailed by trade unions as the destruction of the Slovenian social state. This rhetoric, reminiscent of the old socialist days, has proved significantly detrimental for the reform of the public pay-as-you-go (PAYG) pension system.

Projections by the European Commission have suggested that Slovenia possesses one of the most rapidly ageing populations in Europe; only behind the Southern part of the continent. Estimates suggest that by 2030 40 percent of the population will be dependent on age-related spending. By 2050, the old-age dependency ratio is forecast to increase by an additional 15 percentage points, reaching 55.6 percent in the corresponding year. The total fertility rate has also been declining since the late 1980s. For the period 2005-2010, Slovenia's average fertility rate was eleventh lowest in the world. This, coupled with a retirement age which in 2008 was around 59 years on average, poses significant threats to Slovenia's future.

Continuous lowering of the effective retirement age has exerted a strong pressure on the rise of age-related expenditures. By 2010, public pension expenditure represented 11 percent of GDP. By 2050, expenditure on public pensions is forecast to reach 18.3 percent of GDP-only falling behind Portugal (20.8 percent of GDP) and Cyprus (19.8 percent of GDP). The extraordinary increase in the level of age-related expenditure is not exclusively attributable to the changing demographic landscape, despite Slovenia's significantly aging population.

The most distinctive characteristic of the Slovenian PAYG pension system is unearned benefits. Although the notion of unearned benefits is the cornerstone of social justice, its Slovenian manifestation also deviates substantially from the rationale of actuarial fairness, which forms the basis of the contributory principle in PAYG pension. Unearned pension benefits have been a key feature of Slovenia's waning public pension system. Recipients include former generals, war veterans, civil servants, public officials, academics and even chimney-sweeps. These recipients have accumulated net pension wealth not on the basis of contributory principles, but as the result of special privileges, sustained by the continuation of rent-seeking and interest-group influence in Slovenia. In 2010, the magnitude of unearned pension benefits amounted to €367 million, or just over 1 percent of GDP.[3] Moreover the net present value of pension liabilities increases considerably if one takes into account future benefits. A recent study by the Bank for International Settlements has estimated that the size of Slovenian net pension liabilities will increase to 291 percent of GDP by 2050, (if future net pension liabilities are discounted by 3 percent). This amounts to the second-highest ratio in the Eurozone, only behind Portugal.

The removal of unearned pension benefits from the public pension system would substantially reduce the pressure on long-term fiscal solvency. It would also reinforce the importance of the contributory principle and actuarial fairness in the state pension. The magnitude of unearned benefits embedded in the public pension system demonstrates state capture in the public pension system. It also demonstrates the persistence of interest-group pressure and their strength as powerful coalitions. In Slovenia this phenomenon has translated into the near fiscal insolvency of the state pension system in the medium term. Gradualism's strategy of inducing early-retirement in order to reduce unemployment has failed.

The result of this strategy has been to produce significant intergenerational income imbalances, as well as further rigidities in the labour market and low employment growth. Post-gradualist resistance to comprehensive pension reform has also indicated a preference for maintaining the status quo and appeasing powerful interest groups. Yet maintenance of the status quo threatens to ultimately result in fiscal default.

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[3] I am thankful to Bernard Brščič for providing estimates on the cost of unearned pension benefits in the share of GDP.

VIII. Towards Shock Therapy

Slovenia's economic performance in the last twenty years was initially marked by macroeconomic stabilization and low levels of public debt. However from the second half of the 1990s, the rate of total factor productivity growth –which indicates the level of technological progress - had stalled (Mrkaic, 2002), reaching negligible levels. The stagnation of labour productivity from 2006 onwards suggests that economic growth in Slovenia has been characterized by a capital deepening that eventually diminished the rate of economic growth. Slovenia's transition to market had not been accompanied by enterprise restructuring and large-scale privatization. Unlike other high-income transition countries, a thorough privatization of state-owned companies did not occur, often being undermined by economic nationalism and resistance to foreign direct investment. This lack of enterprise restructuring boosted a wave of resistance to structural change which, coupled with poor contract enforcement, eventually led to a weak and fragile private sector, accounting for little more than 50 percent of GDP.

A rigid and inflexible labour market, the most penetrating socialist legacy, has generated rigid wage determination and rigid employment legislation, characterized by significant trade union intervention. The intervention of unions in the centralisation of collective bargaining and the enforcement of inflexibility in the labour market has resulted in disastrous consequences. Empirical evidence suggests a significant correlation between the degree of a rigidity and insulation from competitive pressures in a labour market and low productivity growth. The aforementioned features of the Slovenian labour market has caused the stagnation of productivity growth to such an extent that in 2007 Slovakia overtook Slovenia in the rate of productivity convergence to the other members of the EU.

The 2008/2009 financial crisis has caused a significant decline in aggregate production and the slow subsequent growth since 2010. Growth prospects in the medium term suggest that Slovenian income per capita is not converging with high-income European countries. To boost long-term economic growth and facilitate technological progress, the course of economic policy should not aim to preserve the status quo, a principle which has dominated national politics ever since political independence. Instead, economic policies should prioritise long-term growth.

First, policy reform should include rigorous and penetrating reformation of the tax system, aimed at the abolition of corporate income tax and the adoption of flat-rate income tax; in order to encourage labour supply and productivity growth. In fact, Slovenia is suffering from one of the highest effective tax burdens, measured as a share of GDP. In 2009 the effective tax rate, which includes social security and mandatory health insurance contributions, amounted to 55 percent - one of the highest rates in the world.

Secondly, it should begin to liberalise the labour market. Much empirical evidence suggests the negative relationship between labour market rigidity and productivity growth. A comparison of overall labour market regulation in a cross-section of OECD countries suggests that the labour market in Slovenia is constrained by excessively-regulated wage determination, employment contracts and entry-exit conditions, making it one of the most regulated labour markets in the OECD after Portugal and Germany.

Thirdly, policies should aim at a transparent and immediate privatization of state-owned production on a significant scale, as well as liberalization of the banking and financial sector, whilst ensuring effective enforcement of competition protection. Poorly enforced competition protection and state dominance in banking, finance and telecommunications is the major constraint for maturing from a transitional to a market economy. The evidence again suggests that better corporate governance, financial fundamentals and market outcomes follow privatization. Privatization and the encouragement of market competition is perhaps the simplest way to tackle the power of interest groups who extract immense rents from the public ownership of large-scale firms.

Finally, the reform of a fragile and fiscally-bankrupt pension system should not be postponed. The net pension liabilities currently implicit in the state pension system have raised serious concerns over the actuarial fairness of a PAYG system which ought to incorporate the compulsory principle (as is usually typical). With an aging population, this reform should facilitate the introduction of mandatory private savings accounts and initiate the transition to fully-funded private pension schemes. The transition should also ensure the better regulation of pension funds. This could be done by enforcing a rigorous compliance with the principles actuarial fairness, and opening up private pension funds to foreign competition.

These suggestions present the first step to boosting long-term growth in Slovenia, a process which must begin by tackling the legacies of its recent economic history. This paper does not provide a definitive account of the mistakes of transition, but instead it attempts to discuss the negative consequences of the gradualist preference for maintaining the status quo. This has persisted throughout transition, to such an extent that Slovenia has started suffer the consequence of policies that prioritise social justice above sound economic principles.

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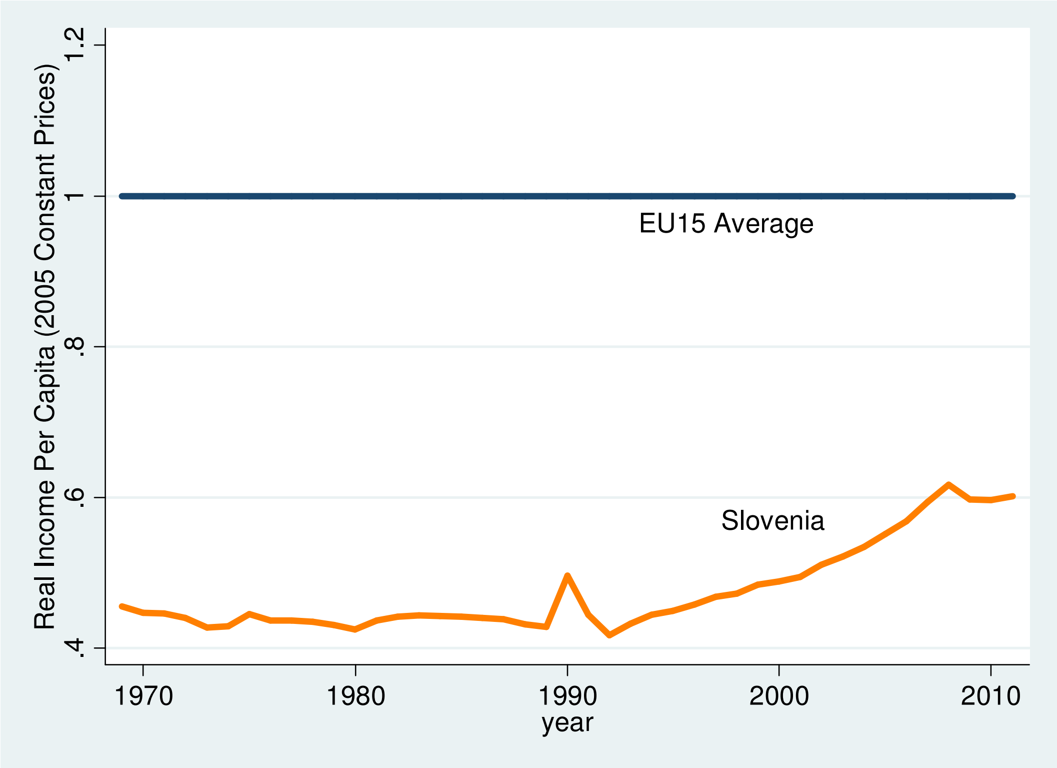
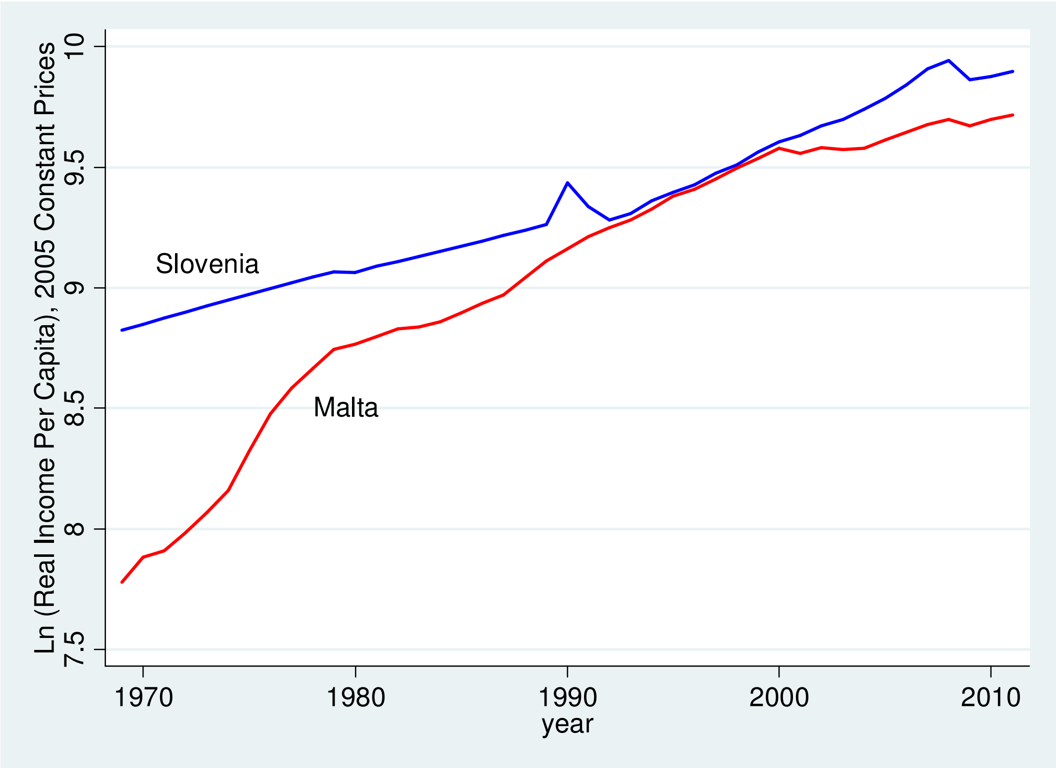
X. Appendix: List of Figures

Figure 1: Real Income Per Capita in Slovenia and EU15



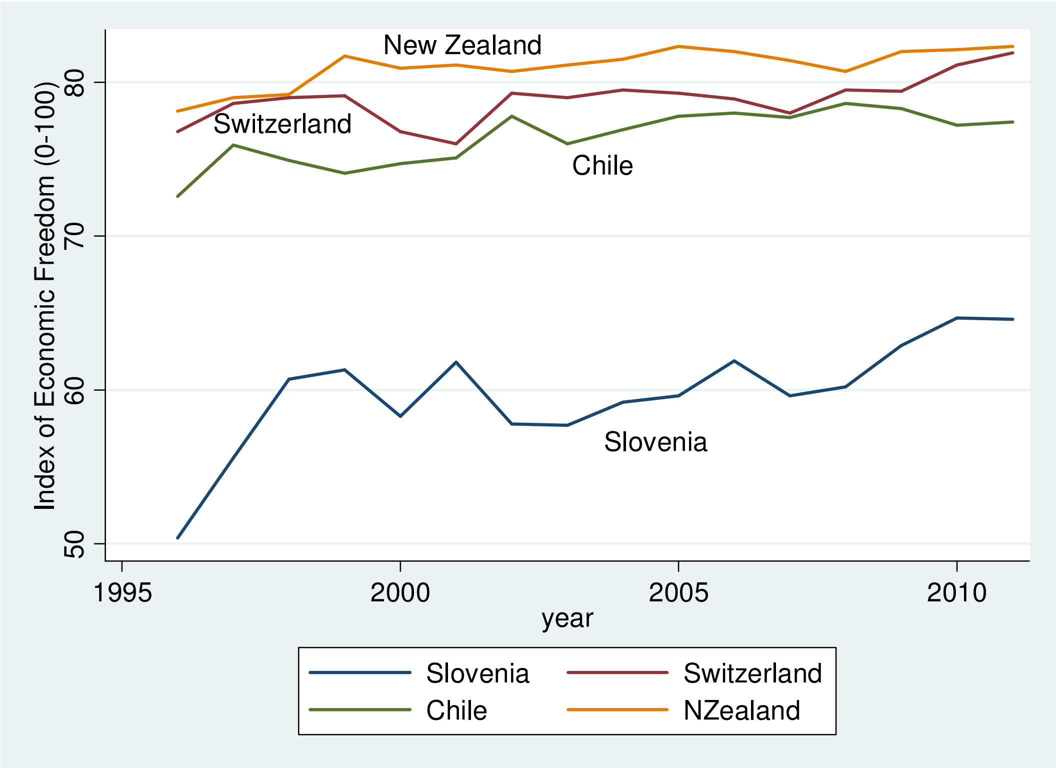
Source: Economic Research Service (2011).

Figure 2: Anatomy of Long-Run Growth Pattern in Slovenia and Malta



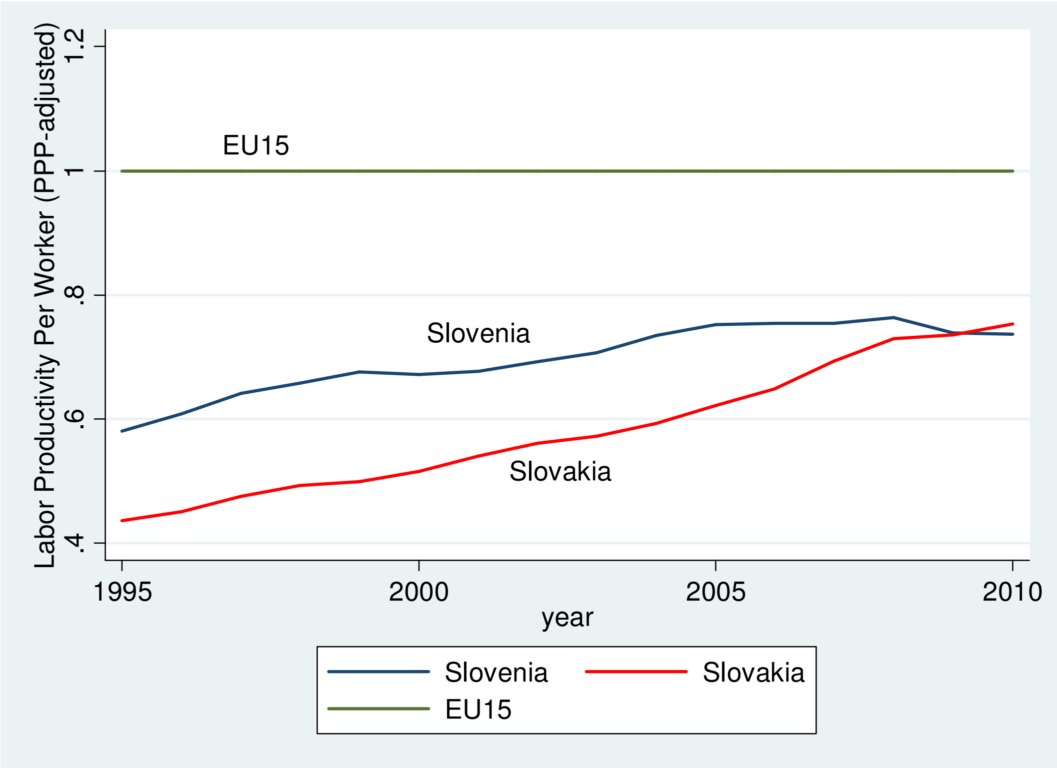
Source: Economic Research Service (2011)

Figure 3: Index of Economic Freedom in Selected Countries



Source: Economic Research Service (2011)

Figure 4: Labour Productivity Growth in Slovenia, Slovakia and EU15



Source: Economic Research Service (2011)