



COUNTRY BRIEFING SLOVENIA

Vienna Institute for International Economic Studies

Industrial Policy for a New Growth Model

Country Briefing Slovenia

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This publication is edited by the FES programme on Economic Development in Central Eastern and South Eastern Europe »European Economies of the East«. The program is headed by Ernst Hillebrand.

Please find all the publications of the programme under its webpage:

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About the authors

Vienna Institute for International Economic Studies:

Alexandra Bykova, Rumen Dobrinsky, Richard Grieveson, Maciej Grodzicki, Doris Hanzl-Weiss, Gábor Hunya, Niko Korpar, Sebastian Leitner, Bernhard Moshhammer, Ondřej Sankot, Bernd Christoph Ströhm, Maryna Tverdostup, Zuzana Zavorská

Special thanks to Maciej Grodzicki (Jagiellonian University), Michael Landesmann (wiiw), Julie Pellegrin (CSIL), Slavo Radosevic (UCL) and Roman Stöllinger (wiiw, WU) for their valuable inputs and guidance in the writing of the report.

CENTRAL AND EASTERN EUROPE NEEDS INDUSTRIAL POLICY TO ESCAPE THE MIDDLE INCOME TRAP

Since the early 2000s, the EU member states of Central and Eastern Europe (EU-CEE) have achieved an impressive economic catch-up process. However, the previously successful model of taking over labour-intensive production steps as an 'extended workbench' of Western corporations has reached its limits. Combined with major global challenges such as decarbonisation and digitalisation, this makes it essential for EU-CEE to develop a new, innovation-based economic model. Only then will these states be able to complete the catch up with Western Europe in terms of productivity and living standards. The situation is exacerbated by the economic consequences of the war in Ukraine, such as permanently higher energy prices and higher inflation, which pose grave challenges for the region's external competitiveness.

The problem is that the central technological competences and those parts of production with the highest added value are located in the 'headquarter economies' of Western Europe. Meanwhile, the EU-CEE countries – Poland, Czechia, Slovakia, Hungary, Slovenia, Croatia, Romania, Bulgaria and the three Baltic states – are still extremely specialised in labour-intensive production. They depend heavily on lower labour costs, and this restricts their prospects of catching up economically with Western Europe. A good example of this is the car industry, which is so important for the region as indicated by its high share of value added, jobs and exports, especially in the Visegrád states, Romania and Slovenia.

The study shows that the EU-CEE countries have so far lacked a constructive approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy, weak investment environments for start-ups, and the activities of state-owned enterprises have not been aligned with the greater development goals. In general, there is a lack of state entrepreneurship in these countries that could nurture promising industries. This is particularly challenging for regions that are lagging behind within countries, as they lack the technical capacities for industrial policy. Due to these factors, the study argues that the EU-CEE countries are struggling to get out of their middle income trap.

Their EU membership offers unique opportunities for industrial policy, but also challenges. On the plus side are access to funds, participation in research networks and the opportunity to shape industrial policy on the EU level. Important-

ly, industrial policy in the EU has taken a much more prominent role in recent years as shown by initiatives such as the European Chips Act or the Important Projects of Common European Interest (IPCEI). This provides some momentum for the development of industrial policy in the EU-CEE countries. Strict state aid rules and an EU competition policy that gives preference to free market principles, on the other hand, are challenges for an effective industrial policy.

As discussed above, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. For countries like Poland, the green transition is a major challenge. This transition can only be managed through huge public investments in green technologies and digitalisation, combined with the right conditions for private enterprise to thrive, to create a fully joined-up approach combining the best of the public and private sectors and academia. This means more money for education, research and development, as well as active labour market policies to manage the transition.

Above all, however, the countries of the region need a strategically oriented industrial policy to support the emergence of more globally competitive companies and to emphasise their own economic strengths. While a true "entrepreneurial state" may be too ambitious for many EU-CEE countries in the coming years, steps in this direction are the way to go. We propose eight steps, that should be taken:

1. Create a national innovation system in each country, bringing together the private sector, universities, key ministries, and business agencies. Within this biotope, new ideas can be developed, tested, and financed. Each country should define which sectors and specialisations are promoted, rather than relying solely on external market forces.
2. Make full use of EU funds and maximise participation in EU research initiatives to advance industrial policy goals. Governments should also get more involved in industrial policy debates at the EU level. Greater participation in the EU's Horizon Europe research funding programme or in the EU's Important Project of Common European Interest (IPCEI) initiative would also be particularly important for the region's technologically less advanced countries.

3. Learn from each other's successes stories to emerge as frontrunners in the digital economy. Estonia is generally well prepared in this area and often raised as an example. However, there are also other positive cases in the region. Romania and Croatia have a particularly high proportion of graduates in ICT, relevant for digitalisation. Czechia shines with its digital start-ups, the Baltic states with the quality of their digital public services. The Visegrád countries and Slovenia have highly digitalised and automated industries.
4. Harmonise investment schemes to attract foreign companies with national industrial policy. Instead of providing blanket support for all investments by foreign companies, national governments should strategically consider which sectors and parts of the value chain they want to attract, and create incentives that maximise the potential for spillovers from foreign giants to domestic firms.
5. Identify and exploit promising niches. Given the lack of technological experience, the establishment of the semiconductor industry in the EU-CEE countries, for example, would not be very promising. However, each country has traditional strengths that should be built upon.
6. Institutional reforms. In some states of the region, the quality of public institutions has declined significantly in recent years. This is worrying. Countries in East Asia have a lot of experience in building adequate institutions for an active industrial policy, even if the framework conditions there partly do not meet Northwest European standards. This experience should be used.
7. Structural change must be cushioned socially in order not to lose the support of the population. EU-CEE countries should aim for a flexible labour market to ease the transition from old to new jobs, but underpin this with extensive retraining programmes and a social safety net that means that workers themselves do not bear the costs of the transition.
8. Each country needs a tailor-made industrial strategy adapted to its specific needs. While the Baltics, for example, are well positioned for the digital transformation, they are struggling above all with distribution problems and a shrinking population. Czechia, Poland or Slovenia are industrially the most advanced, but must make the transition from 'extended workbench' to innovative economy. For the less developed parts of EU-CEE such as Bulgaria and Romania, the priority should be on maximising the transfer and knowledge and innovation from big foreign investors.

COUNTRY BRIEFING SLOVENIA

COUNTRY OVERVIEW

Slovenia's transition to an export-oriented market economy is widely seen as a success, accompanied by solid institutional development and a solid industrial base, which have led to a level of economic development on par, and in some categories exceeding, that of Czechia. Slovenia's manufacturing industry plays a prominent role in the national GDP, surpassing the average share of manufacturing as per cent of GDP of EU-CEE countries by 5 p.p. Industrial production is also comparatively more diversified, with only basic metals and pharmaceuticals exceeding 10 per cent of value added in the total share of manufacturing, and the production of metals and electrical equipment accounting for the largest share of the workforce. Along with the business conglomerate Mercator, Slovenian pharmaceutical firms Krka and Lek (owned by Sandoz, Novartis) are the largest employers in the country¹.

Slovenia is merely average in terms of industrial competitiveness and the total share of high-tech products in manufacturing's value added when compared to the EU-CEE average. Other EU-CEE countries have been catching-up in terms of purchasing power (although most are still well behind), which can be interpreted as a sign that Slovenia has largely maximised its existing industrial base and has been

slow to respond to the opportunities brought by the green and digital transformation. Underinvestment in the private sector, low levels of inward FDI compared to other EU-CEE countries and lingering government ownership in non-strategic sectors, such as tourism, hinder industrial upgrading.

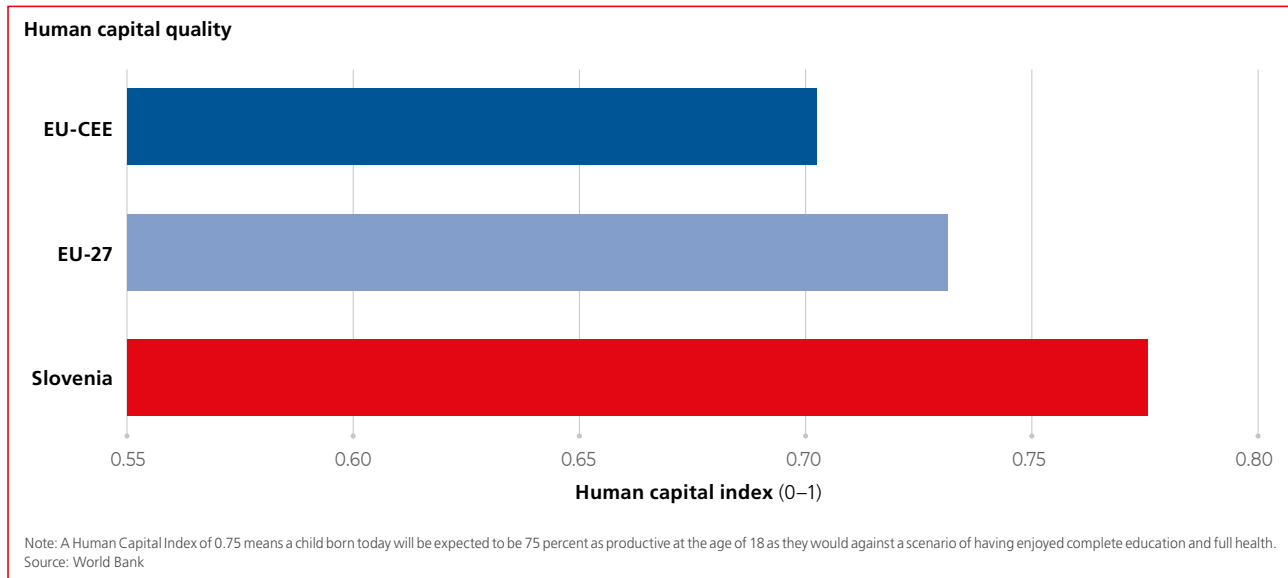
A feature with progressive importance to Slovenia's prospect of overcoming the functional specialisation trap are specialised SMEs, well integrated in global value chains, producing products, such as a car parts, machinery or tools that reach high value added due to innovation, quality and engineering expertise. There are also emerging initiatives to reorient the automotive sector towards electric vehicles (produced in the largest automotive employer, Revoz, owned by Renault) and hydrogen, though larger initiatives to decarbonise the industry are so far absent – a fact supported by zero IPCEIs granted to Slovenia. Slovenia's key strength is its quality of human capital, which even exceeds the EU-average.

Due to relatively higher wages, Slovenia can no longer compete against other EU-CEE countries in labour costs, thus, Slovenia must focus on innovation, high-tech industries and build on positive signals, such as the growing public investment in R&D as a share of GDP, a solid share of enterprises that have undergone the first step digitalisation and build a supportive business environment for successful SMEs with potential to upgrade their positions in global value chains, and gradually turn from suppliers to outward investors.

¹ Based on SloveniaBusiness Top300 in 2021.

Industrial development – I			
	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)	Medium- and high-tech MVA (% of total MVA)
Slovenia	0.11	22	37
EU-27	0.14	15	41
EU-CEE	0.10	17	38

Note: 2020 values. The CIP index assesses the strength and complexity of an economy's industry, with Germany claiming the maximum score in 2020 at 0.42.
Source: UNIDO



INDUSTRIAL COMPETITIVENESS – SWOT

Strengths

- Quality of human capital is the highest among EU-CEE and the labour force is characterized by good knowledge of foreign languages
- Solid engineering base in diverse industries, marked by well-performing manufacturers specialised in high-value added niche products, for example in the automotive industry (Kolektor), space technology (Dewesoft), aeronautics (Pipistrel)
- After years of falling behind, Slovenia has since 2019 increased its share of public investment in R&D above 2 per cent of GDP (currently leading EU-CEE), gained spots in the European Innovation Index (EIS) and has improved its digitalisation performance, especially in the public sector

Weaknesses

- Political divisions and the only recently reversed trend of democratic backsliding lead to mistrust in the government's ability to carry out ambitious development programs, while small size of the country equals in over-representation of particular interests, thus hindering the opportunity to promote state entrepreneurship
- Low share of FDI as per cent of GDP in comparison to other EU-CEE countries driven by the relative difficulty in attracting FDI, due to higher wages and an overall less accommodating business environment
- Undeveloped venture capital market leaves start-ups with few options for financing, which can prompt emerging start-ups to move abroad after the initial growth phase

Opportunities

- High indicators of life quality (including safety, education and healthcare) and proximity of nature make Slovenia an attractive destination for skilled labour force
- The largest car factory Revoz has already partially oriented production towards small EVs, the existing know-how can be leveraged in the green transition

- Embeddedness in global value chains can act as a push factor for greening manufacturing since partners and headquarter companies are often the first to demand ESG strategies, disclosure of non-financial information, etc.; this can already be observed among automotive suppliers
- Large volumes of available biomass and a slowly emerging wood industry represent a major opportunity to develop niche applications for biomass in energy, construction, etc.

Threats

- No consensus on future energy production which may lead to prolonged use of coal in the high-emitting thermoelectric plant Šoštanj, increased energy imports dependency and higher prices for the industry compared to other EU-CEE countries
- Ageing domestic workforce and lack of lower-skilled workers, showcased by the high share of surveyed Slovenian companies who see labour shortage as a critical issue (70 %) – this share is highest in Europe. Solving the situation will require more inward migration, however, the current migration policy is restrictive
- A small number of energy intensive companies that produce 2,5 per cent of GDP uses one sixth of all energy needs of Slovenia; the energy transition could hamper their competitiveness further and could lead to job losses
- The pharmaceutical industry is partially tied to the Russian market where pharmaceutical company Krka owns a manufacturing subsidiary; the full effect of sanctions and deteriorating relationships is yet unclear

INDUSTRIAL POLICIES AND STRUCTURAL REFORM DEVELOPMENTS

FDI promotion and value chain upgrading

- Law on promoting investments, implemented in 2018, allows for smaller subsidies (via public calls) and case-based larger public participation in projects fea-

turing foreign capital. Public support is meant to incentivize digital and green development and research and innovation and may not be given to certain low-tech sectors (such as steel, mining, energy, etc.). No distinction is made between domestic and foreign investments.

- The national Smart Specialization Strategy (S4, and in draft version, S5) promotes value chain upgrading through developing R&I networks based on thematic areas, promoted within the Strategic Development and Innovation Partnerships (SRIP), including partnerships for developing “Smart factories” and “Smart materials”, which have been introduced with varying levels of success.

New technologies, digitalisation, innovation

- The Strategy of Digital Transformation and the national Industrial Policy 2021–2030 set KPIs and outline key strategic directions for the digitalisation of the industry, namely the support for digital transformation of companies (products, processes and sales) and introduction of Industry 4.0 concepts and technologies, such as AI, robotics and the internet of things
- The Recovery and Resilience Plan (RPP) outlines reforms for the digitalisation of the economy based on the above-mentioned tenets of the national Industrial Policy and allocates funding for a public call for supporting the digital transformation of companies (EUR 44 million) and co-financing RRI projects related to digitalisation (EUR 20 million); however, both programs are small compared to total of available grant funds in the RPP (EUR 1,800 million)

Green transformation of industry

- Green development is described as one of the primary strategic directions of the Slovenian Industrial Policy 2021–2030 and connected to national energy and climate goals by accelerating the transformation of industry, with few concrete steps outlined in the document
- The Recovery and Resilience Plan allocates 30 per cent of funds for the green transition, mainly to energy efficiency and circular economy, however, the total extent of direct support for the industry is small, only EUR 5 million allocated for energy efficiency projects for companies and EUR 5 million allocated to projects for accelerating the transition to the circular economy (which will only partially fund companies)
- The national Climate Change Fund, fully funded by the income from the ETS is currently not transparent, inefficient and does not enable the funding of transformational projects to green the economy; changes to the programme are expected in 2023

COUNTRY-SPECIFIC RECOMMENDATIONS

In the main part of the study, we identify Slovenia as one of the wealthiest and more industrialised parts of the region, where the core focus should be on making the switch from imitation to innovation-driven growth. Policymakers should target the cultivation of a National Innovation Sys-

tem, wider participation in common EU projects, and investment in human capital. Specifically, we propose the following policy priorities:

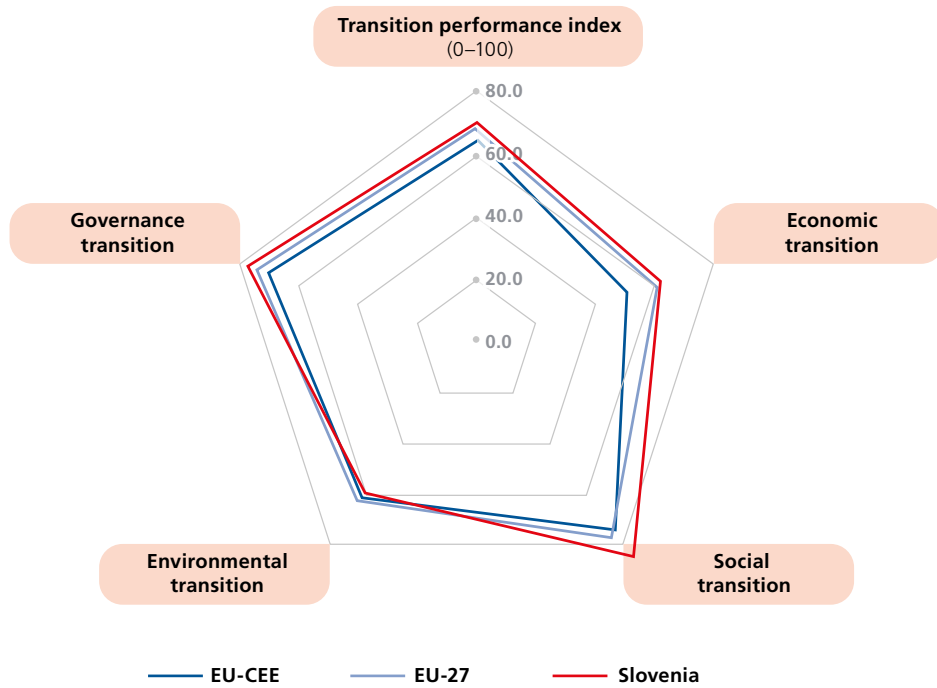
- **Upgrade the support ecosystem for innovative SMEs with high potential for growth and upgraded positions in global value chains.** Focus on fast-growing companies that operate in high-tech sectors or manufacture complex and innovative products. Accelerate their potential for scaling-up of production and R&D activities by improving the business environment, lowering the tax burden on skilled workforce and leverage the state’s potential to provide funding. There are multiple promising niches emerging in Slovenia as shown in this briefing, and the expansion from SMEs to large companies ought to be enabled through better access to funding (see policy recommendation 5.5 of the main report, where we highlight the importance of identifying successful niches). Explore the options for strategic entrepreneurship of the state in fast-growing companies to reduce risk for private investors.
- **Reorient FDI policy towards attracting investments that allow for ascension in global value chains.** Build on stories of successful cooperation for the promotion of greenfield investments (such as the robot manufacturer Yaskawa) and offer incentives conditional on the establishment of business functions with higher levels of added-value global value chains (such as R&D centres). Build on a solid reputation of institutional quality, quality of life and healthy living environment, proximity to large population centres to attract the establishment of various higher-level functions, such as R&D, design or regional headquarters. Such actions shall require better coordination between ministries responsible topics, such as investment policy and labour policy, as laid out in the policy recommendation 5.4 of the main report.
- **Capitalize on the green transition.** Slovenia’s economy is small enough to allow for dealing with specific issues on a case-by-case basis. Certain companies, such as steel producer SIJ are already using best-in-class technologies and are introducing circular economy principles to production. Active industrial policy should promote deeper engagement with companies in order to design roadmaps that will allow energy-intensive industries to fully decarbonize without succumbing to various transition risks. This goes in line with the entrepreneurial approach we defined in the main report, whereby the state forms a collaborative network with key ministries, academia, business agencies and the private sector. Furthermore, the national climate change fund should be used to fund support schemes, such as Carbon Contracts for Difference and technical assistance for developing complex projects that can compete for funding from programs, such as the EU Innovation Fund. In parallel, build on Slovenia’s solid performance in the Eco-Innovation index (best among EU-CEE) to support niche companies offering green products or various higher-end applications developed from biomass.

Industrial development – II

Sector	Percent of manufacturing employment
Fabricated metal products, except machinery and equipment	16.3
Electrical equipment	10.7
Rubber and plastic products	7.8
Food products	7.7
Motor vehicles, trailers and semi-trailers	7.4
Machinery and equipment n.e.c.	7.2

Note: 2018 values.
Source: Eurostat Structural Business Statistics.

Transition performance scorecard



Note: 2020 values. The TPI scores countries based on 4 pillars of a transition to a more sustainable, inclusive and resilient economy.
Source: European Commission

Slovenia



COUNTRY OVERVIEW

INDUSTRIAL DEVELOPMENT

High level of economic development. Manufacturing plays a prominent role and industrial production is diversified.

There are specialised SMEs, well integrated in global value chains, producing products that reach high value added due to innovation, quality and engineering expertise.

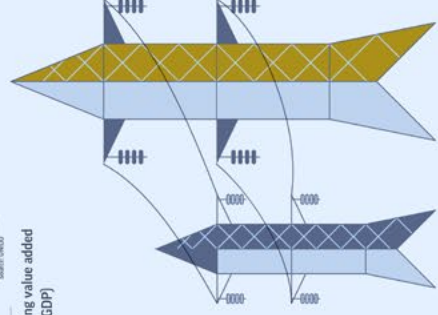
Quality of human capital lies above the EU-average.

SLOVENIA	0.11	22%
EU-27	0.14	15%
EU-CEE	0.10	17%

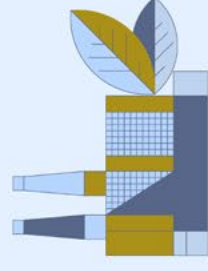
Competitive industrial performance index

Manufacturing value added (MVA) (% of GDP)

Note: 2020 data through and comparison of Germany (2020) and the average of EU-CEE (2020).



INDUSTRIAL COMPETITIVENESS – SWOT



- ### STRENGTHS
- High quality of human capital; labour force with good knowledge of foreign languages
 - Solid engineering base and well-performing manufacturers specialised in high-value added niche products.
 - Public investment in R&D above 2% of GDP (currently leading EU-CEE).



- ### WEAKNESSES
- Political divisions and over-representation of particular interests
 - Low share of FDI as % of GDP in comparison to other EU-CEE countries.
 - Underdeveloped venture capital for start-ups.



- ### OPPORTUNITIES
- High indicators of life can attract skilled labour force
 - Initiated production of small EVs whose know-how can be leveraged in the green transition
 - Embodiedness in global value chains can accelerate the greening of manufacturing.
 - Large volumes of biomass and emerging wood industry represent opportunity to develop niche applications for biomass in energy, construction, etc.



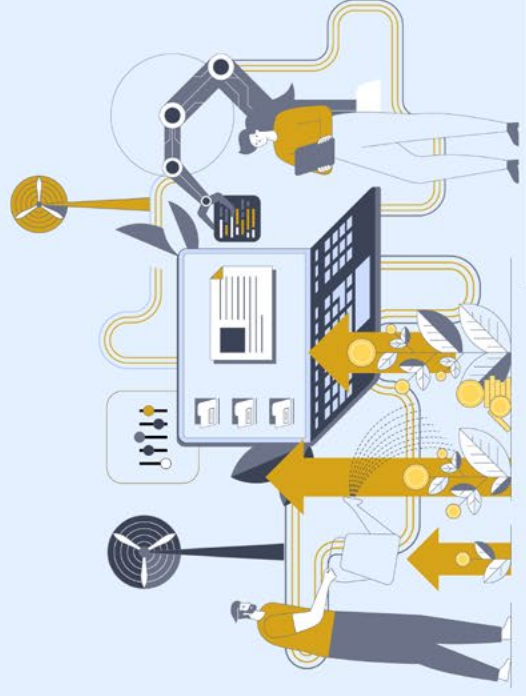
- ### THREATS
- Lacking consensus on future energy production can create problems with energy supply, prices and emissions.
 - Ageing domestic workforce and lack of lower-skilled workers.
 - Energy transition could hamper competitiveness of some energy intensive companies
 - The pharmaceutical industry is partially tied to the Russian market.

WHAT SHOULD BE DONE?

COUNTRY-SPECIFIC RECOMMENDATIONS

The focus should be on switching from imitation to innovation-driven growth. This needs the cultivation of a National Innovation System, wider participation in EU projects, and investment in human capital.

- **Upgrade the support ecosystem for innovative SMEs with high potential for growth and upgraded positions in global value chains**, focusing on fast-growing companies that operate in high-tech sectors or manufacture complex and innovative products.
- **Reorient FDI policy towards attracting investments that allow for ascension in global value chains**, trying to attract the establishment of various higher-level functions, such as R&D, design or regional headquarters.
- **Capitalize on the green transition** to support niche companies offering green products or various higher-end applications developed from biomass.



IMPRINT

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Friedrich-Ebert-Stiftung

Publisher: Friedrich-Ebert-Stiftung Budapest

1054 Budapest | Fővám tér 2–3.

Email: fesbp@fesbp.hu

Responsible for content and editing:

Ernst Hillebrand, Head, European Economies of the East

ernst.hillebrand@fes.de

Orders/Contact: fesbp@fesbp.hu

ISBN 978-615-6289-51-3

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Design/Typesetting: pertext, Berlin

Cover photo: Nataliya Hora / Shutterstock.com

Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries

This country briefing is a short summary of a much broader study that deals with the perspectives of industrial policies in Central Eastern and Southern Eastern Europe and the question how these countries can avoid to get stuck in a middle-income trap. The study has been authored by a team of experts from the Vienna Institute for International Economic Studies on behalf of Friedrich-Ebert-Stiftung.

The study argues that the EU-CEE countries have so far lacked a systematic approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy and weak investment environments for start-ups, while the activities of state-owned enterprises have not been aligned with the greater development goals.

Hence, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. This transition can only be managed through public investments in green technologies and digitalisation, education and infrastructure, combined with the right conditions for private enterprise to thrive.

The study includes eleven country profiles that analyse the economic and industrial structures for their strengths and weaknesses and identify possible courses of action for an active industrial policy.

The full study can be found here:

<http://library.fes.de/pdf-files/bueros/budapest/20260.pdf>



Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries

Vienna Institute for International Economic Studies,
Friedrich-Ebert-Stiftung Budapest, 2023, 103 Seiten,
ISBN 978-615-6289-36-0