OECD Economic Surveys

Slovak Republic

OECD

Volume 2004/1 – March 2004

OECD ECONOMIC SURVEYS

2004

Slovak Republic

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

– to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
– to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and
– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and the Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

Publié également en français.

Table of contents

Tables

Figures

BASIC STATISTICS OF THE SLOVAK REPUBLIC (2002)

THE LAND

Area (sq.km)	49 035	Inhabitants in major cities (end-2001)	
Agricultural area (sq. km)	24 440	Bratislava	428 094
		Kosice	236 036
		Presov	92 720
		Nitra	87 308

THE PEOPLE

Population (thousands)	5 379
Inhabitants per sq. km	110
Average annual population growth (1990-2002, per cent)	0.1
Infant mortality (per thousand live-births, 2000)	8.6
Life expectancy (2000) : Males	69.2
Females	77.4
Registered unemployment, % of the labour force	18.0
LFS unemployment, % of the labour force	18.5
Employees (thousands, Labour Force Survey)	2 127

PRODUCTION

GDP (billion SKK)	1 096.4
GDP per capita (in US$, market exchange rate)	4 406
Gross domestic investment (% of GDP)	29.8

THE GOVERNMENT

		Composition of the National Council of the Slovak Republic (elections of September 2002):	
Per cent of GDP			
General government revenue	43.6	Movement for a Democratic Slovakia	35
General government expenditure	50.8	Slovak Democratic and Christian Union	27
Public debt	38.2	SMER	24
Official foreign debt of the government and the National Bank of Slovakia	15.3	Hungarian Coalition Party	20
		Christian Democrat movement	15
		Alliance of New Citizen	14
		Communist Party of Slovakia	11

FOREIGN TRADE

Exports of goods and services, % of GDP	71.8	Imports of goods and services, % of GDP	78.9
Main exports of goods, % of total		Main imports of goods, % of total	
Machinery and transport equipment	39.6	Machinery and transport equipment	38.2
Manufactured products	41.0	Manufactured products	28.8
Chemical products	6.9	Chemical products	10.7
Others	12.5	Others	22.3

THE CURRENCY

Monetary unit: Slovak Koruna	
Currency units per US dollar (period average)	
Year 2002	45.3
December 2003	33.5

This Survey is published on the responsibility of the Economic and Development Review Committee *of the* OECD, *which is charged with the examination of the economic situation of member countries.*

•

The economic situation and policies of The Slovak Republic *were reviewed by the* Committee *on* 24 November 2003. *The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole* Committee *on* 16 December 2003.

•

The Secretariat's draft report was prepared for the Committee by Rauf Gönenç, Peter Walkenhorst *and* Jaromir Cekota *under the supervision of* Yutaka Imai.

•

The previous Survey of The Slovak Republic *was issued in* June 2002.

Assessment and recommendations

Growth is strong and macroeconomic imbalances are being reduced, but unemployment remains too high

The Slovak economy is on a high growth path driven by growing foreign direct investment (FDI) inflows, attracted by a favourable operating environment in a country soon to be integrated in the EU. It is striking in that connection that, with labour costs remaining the second lowest in OECD, Slovakia is set to become the top OECD manufacturer of cars per capita next year. Real GDP is growing at around a 4 per cent annual rate, exports are expanding steadily and private domestic demand is robust. The current account deficit has returned to a more easily sustainable level. Wages are rising in line with labour remains subdued as local businesses lag the highly productive FDI firms, and domestic services and self-employment remain underdeveloped. Willingness to work is also undermined by a welfare system which has been extremely generous for a long time. The resulting unemployment, concentrated among the low skilled, the young and the elderly outside the Bratislava area, remains very high (at 17 per cent on a survey basis in the fall of 2003) and will come under additional pressure as a result of job cuts in general government and public utilities.

Economic policy faces three main challenges…

The authorities face three main challenges. First, their aim of joining the euro area as soon as the nominal convergence criteria will have been met on a sustainable basis sets a demanding macroeconomic agenda. A significant reduction in fiscal deficits is required, not only to meet the fiscal rules but also to pursue disinflation objectives without an excessive tightening of monetary conditions that would impact negatively on growth and employment creation. Second, the employment rate needs to be raised through radical changes in the incentives to both supply and demand of labour while maintaining households' confidence and political support for government policies. The recently introduced legislation to strengthen work incentives should be fully enforced. Third, there is an obvious need to push for smaller and more effective government, against a strong constituency in favour of maintaining the status quo which entails one of the highest shares of general government jobs in total employment among OECD economies. Public sector reform is necessary not only to support fiscal consolidation but also to promote a pro-growth environment. Radical transformations are needed in the public sector to assert the rule of law, to enforce impartial and reliable business regulations, and to develop more effective infrastructures for education, training and transportation across the territory.

… which are intended to be met by a bold reform programme…

The new government elected in September 2002 initiated a set of major reforms in the face of these challenges. On macroeconomic policy, the authorities have formally committed to curbing fiscal deficits on a sustained basis, thereby alleviating the burden of economic stabilisation on monetary policy. The independent Central Bank has already been successful in pursuing its disinflation policies, but fiscal consolidation is required to allow for more supportive monetary conditions. The government has also begun to stimulate labour supply and demand with major measures. Welfare benefits available for able-bodied citizens remaining voluntarily unemployed are being massively reduced, while the retirement age is being increased and pension benefits made dependent on work and contribution history. Employers' incentives to hire are being strengthened by labour code reforms making both permanent and temporary job creation less costly; and targeted employment subsidies will be introduced in 2004 for the long-term unemployed. Incentives for small size businesses and the self-employed have been increased by sharp reductions in both the corporate and personal income tax rates, by easing the regulatory environment for businesses, and by adopting competition and public procurement policies that facilitate new entries.

… where interaction between policies is essential

Each of the individual components of this bold reform programme – launched only a year ago and still in the process of being put into application – is important on its own right, but the contribution to overall economic success will be magnified through the interactions among these reforms. The private sector's response to enhanced incentives for investment and job creation is of central importance, and could well exceed the temporarily adverse impact of fiscal consolidation, net of monetary easing, on growth and employment. More competition and new entry in services should facilitate disinflation and help reduce the inflation gap between tradables and non-tradables, while labour market reforms should further enhance the nominal flexibility of wages and help monetary policy to attain inflation objectives. The impacts of this reform package on the living conditions of the low-skilled and long-term unemployed is a legitimate concern, but short-term strains are expected to be offset by increased employment. Nevertheless, additional measures may be needed. As unemployment rates differ significantly with respect to educational achievement (the proportion of the 25-to-64 year old males in unemployment ranges from 4.5 per cent for those with tertiary education to 44 per cent for those with less than upper secondary education) training policies should focus on improving the re-employment prospects of the disadvantaged groups. The policy challenge, for both growth and equity reasons, is to fully reap the latent synergies between macroeconomic, labour market, business sector and public sector reforms.

Fundamental tax reform aims at enhancing efficiency

A comprehensive tax reform has been launched to enhance incentives for entrepreneurship and work, increasing the transparency of the tax system, and reducing distortions from exemptions and double taxation. The core of the reform consists of a flat marginal rate of 19 per cent on all personal and corporate incomes, while the deductible allowance for low income earners is increased. Virtually all tax exemptions are eliminated, whereas the real estate transfer, gift, and inheritance taxes are abolished. A uniform value-added tax rate of 19 per cent is applied to all products and entails a major shift in the tax burden from direct to indirect taxes. These changes have become effective from January 2004 and should enhance efficiency by treating different forms of income more equally. According to official projections, the overhaul of the tax system should be revenue-neutral, but the multi-faceted nature of the changes and data limitations on household incomes make projections tentative. The authorities should provide for contingency plans and measures to face any revenue shortfalls upon implementation in 2004.

Monetary policy has been fulfilling its tasks but faces a big challenge in managing the transition towards euro adoption

The Central Bank has been successful over the past several years in furthering disinflation despite large, though necessary adjustments in administrated prices towards cost-recovery levels. Disinflation has been helped by currency appreciation and international price moderation, but the key to successful disinflation thus far has been the ability of the Central Bank to contain second-round effects of administered price hikes through active policies. Core inflation has been kept slightly below the target range of 3.2 to 4.7 per cent in 2002 and within the target range of 2.1 to 3.6 per cent in 2003. Over the same period the trend appreciation of the currency has been kept on a smooth path, broadly in line with productivity gains, in spite of the strong capital inflows associated with EU accession. Monetary policy will need to continue on its present narrow path between inflation targets and competitiveness considerations. This may become a challenging task in view of possible volatility in capital flows prior to participation in the euro area, as pressures for appreciation are likely to increase and the need for interventions and sterilisation may grow. In these circumstances fiscal consolidation must be geared to alleviate the burden on monetary policy.

Rapid fiscal consolidation is required

The fiscal position on a cash basis continues to be undermined by the lasting effects of the distortive policies of the mid-1990s, notably the ex-post costs of massive government credits and guarantees granted during that period. Furthermore, important tax cuts since 2000 have decreased government revenues and made fiscal management more difficult. Budget deficits were nevertheless beginning to be tamed in 1999 and 2000 before ratcheting up strongly in the run-up to the 2002 elections. The 2002 deficit reached 7.2 per cent of GDP on an ESA-95 (European System of Accounts) basis. In 2003 the new government succeeded in building up support for a rapid Maastricht criteria compliance strategy, and this underpinned a first cut at consolidation, with a targeted ESA-95 deficit below 5 per cent of GDP. The authorities have stated their intention to reduce the general government deficit below the Maastricht benchmark of 3 per cent of GDP by 2006. This amounts to a fiscal consolidation of more than 1 per cent of GDP per year. Such a consolidation path is appropriately ambitious, but achieving it will require a substantial effort. The major risks to this strategy pertain to possible spending slippages, notably in health care, and to the uncertain revenue impacts of the tax reform planned for 2004.

… and should be implemented through a medium-term fiscal strategy

In these circumstances, a medium-term fiscal consolidation strategy is indispensable to keep fiscal outcomes in line with objectives on a sustainable basis. The government aims at developing such a policy. The latest pre-accession economic programme submitted to the EU presents medium-term objectives which can be made more visible to the public and more operational in domestic policymaking. To this effect, the government intends to submit a three year budget framework to the Parliament starting with the 2005 draft budget. The medium-term objectives of this framework should be explicitly based on strategic spending priorities and conservative macroeconomic assumptions, and contain built-in adjustments to contingencies on both the spending and revenue sides. Making such framework conditions binding is a politically challenging task, but the government should seek to achieve this.

Strong incentives are being introduced to stimulate work…

Major reforms have been introduced to sharpen the incentives to work. The welfare system is being overhauled, cutting benefits by one half for the able-bodied citizens who remain voluntarily unemployed. Slovakia still remains the country with the highest unemployment rate for the low-skilled in the OECD area (at close to 40 per cent), and with the lowest employment rate of the population aged 55 to 64 (at close to 20 per cent). The pension reform voted in 2003 directly links benefits to contributions and thereby improves work incentives. Child and family benefits are also being reformed and will be distributed partly as tax bonuses in order to reward earned incomes. Registration for unemployment, a condition for getting access to welfare benefits, is also being made tighter in order to exclude employees working in the informal economy. These measures can be expected to substantially increase the willingness to work. To enhance the employability of the jobless and upgrade employment services, new measures have been voted by the Parliament and further initiatives are under way. The efficacy of such policies is particularly important for the Roma minority which represents about 8 per cent of the total population but 50 per cent of the long-term unemployed, partly as a result of functional illiteracy related to inadequate basic education. While international experience is that the returns to basic education for adults are low, substantial investment in adult education and training seems warranted in the Slovak context.

… and labour demand

Major reforms have also been launched to activate labour demand. Changes introduced recently in the labour code have simplified procedures for hiring, firing and re-assigning employees and facilitate temporary and overtime work. Further cuts in social contribution rates, which remain among the highest in the OECD area and bear heavily on the low-skilled, must be a priority for future changes in the tax-benefit system. As a proxy for such cuts, targeted employment subsidies amounting to 30-40 per cent of total employment costs have been announced for enterprises hiring the long-term unemployed in high-unemployment regions. This measure is welcome, and sufficient funding should be secured in order to cope with a hopefully positive response by the private sector. Additional reforms broaden further the basis of growth beyond the FDI-core sector, by encouraging self-employment and small scale businesses in job-intensive service activities. While a key stimulus is provided by the tax reform, a simplified legal framework for enterprise registration is being introduced and reformed collateral rules should facilitate credit provision to small firms. Public procurement and competition policies are also being strengthened to create a level-playing field for all enterprises. It is intended to equalise business conditions – and improve tax collection – by prosecuting unregistered economic activities. This makes the reform of the social contribution system all the more important: entrepreneurs moving out of the informal sector can survive if their formal obligations remain commensurable with their ability to pay; some transition measures to assist such move could be contemplated.

The enforcement of the new institutional framework necessitates more effective government…

More fundamentally, what is required is a more effective and more reliable court system, including for the registration of new businesses and the handling of bankruptcies. Better staffed and resourced competition authorities to deal with predatory and other anti-competitive practices, and credible sectoral regulators governing the energy, transportation and communications infrastructures are also needed to underpin a market-friendly legal environment. Small enterprises which have no political leverage on the government to protect their property rights, and no direct bargaining power *vis-à-vis* incumbent utility firms need such a framework. Little progress has as yet been achieved in the governance of the court system, the credibility of the police and the assertiveness of economic regulators; and shortcomings are regularly reported in the implementation of various components of the new legal framework. The government is aware of these problems and new laws are being prepared on *conflicts of interest* in public office and the *asset-declarations* of elected officials and civil servants. These efforts require time to obtain results, and the resistance shown by private interests needs to be rapidly overcome.

… including in the areas of environmental policy and tax collection

There is a recognised need for less costly environmental policies, which will become more binding and more demanding, especially for small enterprises, in the course of EU accession. A wider recourse to economic instruments is advisable and this will require an improvement in public management capabilities. In the area of air quality which has been a serious concern in Slovakia, fuller recourse to emission charges and tradable emission permits would reduce regulatory costs. Another area where public management capabilities must be enhanced is tax collection. Wider use should be made of individual tax returns for a more integrated management of tax, welfare, family and other benefits and incentives. Finally, Slovakia's ability to fully draw on available EU Funds for its public and infrastructural investments also depends on the quality of its public service.

A thorough public sector reform is required…

The core challenge faced by the government is to substantially enhance the quality and efficiency of public sector service delivery in a wide range of areas, while reducing its fiscal costs. The dilemma is not insurmountable in the Slovak context because of the very large inherited inefficiencies built into public spending. The new government is engaged in a fundamental overhaul of the public spending system on the basis of reforms in three areas:

– the introduction of strategic and performance based budgeting,

– decentralisation and subsidiarity in the provision of public services, and

– a thorough transformation of the public employment regime.

These ambitious measures have been launched only recently and are in their teething phase. It is important to implement them effectively in order to maximise their benefits, increase their credibility and exploit their synergies.

… including strategic and performance-based budgeting…

Fiscal consolidation should not be based uniquely on spending limits. The most needed adjustments and improvements in government services, public employment and social transfers do not automatically follow from budget cuts. OECD countries' and Slovakia's own recent experience shows that across-the-board cuts may bring about undesirable consequences such as infrastructure attrition, adverse selection in the quality of civil servants, and increased room for corruption in the conduct of public affairs. Targeted reductions in service capacities in lower priority areas are preferable, even if designating such targets is politically more difficult than across-the-board cuts. Strategic and performance-based budgeting are essential tools for this purpose and the government plans to generalise them in the forthcoming budgets, on the basis of lessons from ongoing pilot experiences. Strategic and performance-based budgeting should be utilised more actively to reallocate spending, from lower to higher priority areas.

… decentralisation and subsidiarity in the provision of public services…

Following a set of laws voted in 2001 and further executive decisions in 2003, Slovakia is making a leap forward in regionalisation. Responsibility for providing the main public services, including education, health, railway and social welfare services, have been transferred to sub-central governments as of 2003. Sub-central layers are still funded by the central government, but transfers will be less and less tied to specific uses, and funding will be secured mostly by bloc grants from 2005. This is expected to give regions and municipalities incentives for savings and service improvements so that the central government will be able to scale back overall funding in line with the efficiency gains generated by decentralisation. While this ambitious reform offers opportunities for expenditure rationalisation, it also presents risks. Sub-central governments may become more effective than the central government in the provision of services but only if they remain fully accountable to local constituencies and are liberated from supplier interests. The central government should define and enforce core performance standards to ensure the quality of the public services across the territory, but needs to avoid micromanagement to prevent weakening the accountability of sub-national governments. Sub-central governments are subject to quite detailed fiscal disciplines specified in the decentralisation laws, and these disciplines must be strictly enforced, including with respect to possible off-budget loopholes. Full fiscal transparency at sub-central levels through regular procedural and functional audits must be ensured. Perhaps most importantly in a longer-term perspective, user satisfaction and service performance should be closely monitored across regions and the comparative information made public. The development of a "culture of transparency" through this means would, over time, substantially ease the conflict between the goals of decentralised responsibilities and globally sound public finances.

… and an overhaul of the public employment regime

A new public employment regime has been put in place to provide for quantitative and qualitative changes in public sector employment. The new State Service Act prescribes the needed qualifications and the contractual provisions for 36 000 central administration jobs, and a Civil Service Act specifies corresponding provisions for more than 400 000 general government work positions, including in sub-central governments. Detailed procedures for the verification and certification of the required skills and qualifications, with related adjustments in the contracts offered, are meant to facilitate the firing of unqualified persons and their replacement by new recruits. The early experience with the implementation of this framework has been disappointing. The examinations and tests could not be implemented, and no significant employment adjustment has been recorded on the basis of the new provisions. The regionalisation reform interferes somewhat with the enforcement of the new regime, as sub-central authorities have discretion over their own personnel management. In the short-run authorities need to evaluate the obstacles to the implementation of the new laws, which are fundamentally aimed at overcoming corruption and nepotism in public sector employment. At the same time, care must be taken to assure that these laws do not become barriers to flexibility and adaptation in the public sector to changing requirements.

Results will be particularly critical in education services...

A thorough reform of the education system is necessary, as emerging human capital needs are not well serviced at present. The government has decided to decentralise the ownership of primary and secondary schools to municipal and regional governments, and to fund expenditures according to the number of pupils in each region. Sub-central governments will be left with a wide discretion in the management of education institutions. International experience suggests that this is an appropriate choice. But this same experience suggests that the central government needs to define performance standards in order to preserve the quality of education across the entire territory. This is particularly important for the Roma children who face the double-handicap of weak support from family environments and high failure rates in the school system. The decentralised approach should allow sub-central governments to experiment with more effective policies to meet the set standards, including on the basis of increased competition between public and non-public schools. In the area of tertiary education, available capacity falls short of demand, and the government aims at encouraging pluralism and new entries by transforming universities into autonomous institutions and putting in place tuition fees and student loans. The authorities should ensure that professional and academic bodies which control the creation of new universities do not slow the adaptation of supply. Reforms are also necessary in the training and re-training system for the existing labour force. While large firms are well-equipped to cater to their own training needs, better performing market services would support the entire society. Market-relevant re-training is particularly important for adults with low or obsolete skills and government schemes should be targeted in priority towards these groups. The government can nurture a more effective training culture by directing existing subsidies on a competitive basis and according to provider performance.

... in infrastructures...

Small and medium sized firms need to obtain better access to fairly priced and high quality infrastructures. Programmed regulatory reforms in energy, telecommunications and transportation should be fully enforced and completed, in order to give firms of all sizes swift access to competitive services across the territory. Benefits of competition should be made available not only to large-size eligible customers, and to enterprises with strong bargaining power *vis-à-vis* incumbent utility firms, but to the entire business and household sectors. In certain areas such as railways, Slovakia could move more rapidly than the gradual calendar of EU directives. Following the recent separation of the track infrastructure as a state-owned company, the quality of the transportation system could be considerably strengthened by proactively opening passenger services to competition, and privatising the freight arm of the national railway company to a qualified international enterprise. Road construction should also be upgraded in better match with neighbour countries' networks and, possibly, with wider recourse to private investment. But lessons from public-private partnerships in road operation in the neighbouring Czech Republic and Hungary should be taken into account in designing projects so as to maximise public benefits while limiting fiscal liabilities.

... in the pension system...

The pension reform applicable from 2004 will enhance the public pay-as-you-go (PAYG) balances by increasing the statutory retirement age from previously 60 for men and 55 for women to 62 for both genders, which is a major step towards improving the viability of the scheme. The system remains nevertheless financially unsustainable in the long term. The planned defined benefit scheme with its strict link between contributions and benefits should, upon completion, transform workers' perception of pension contributions from quasi-taxes to quasi-savings. Further changes in the PAYG system are desirable, notably the standard retirement age should be raised progressively to 65 for both genders. A funded second pillar is planned to complete the system and to bring the necessary top-ups to the PAYG benefits which will decline as a percentage of average wages. Replacement rates will decrease sharply for low wage earners at the end of a three-year transition period, and authorities should check if trend wage growth will be sufficient to provide a minimum retirement income for all. A special issue related to the phasing-in of the second pillar concerns the fiscal compensation of the main pillar from the state budget, for the diversion of PAYG contributions. These may amount to about one per cent of GDP per year in the short-term and will likely increase in the following decades. As long as no agreement is reached with the European institutions for the exclusion of such compensation from current expenditures, Slovak authorities will be faced with a difficult choice between postponing or downscaling the second pillar reform, delaying convergence with Maastricht rules, or seeking yet further spending cuts.

… and in the health sector

The health care system is also being reformed with the primary aim of ensuring its financial viability by making all stakeholders accountable for their decisions, at least partially. Patients are to be presented with a clearly-defined basic benefit package and a structure of co-payments, both of which have been absent in Slovakia. The ownership of hospitals is being devolved to lower levels of government, and service providers are to face financial discipline imposed by for-profit insurance companies that compete for subscribers. While reform intentions are admirable, much will depend on the detail of the reform design and implementation, including the breadth of the basic benefit package, the size of co-payments and the regulation of insurers to generate incentives for improved efficiency rather than risk selection. Moreover, the deregulation of health prices and decentralisation will reduce the policy levers for costs control available to the government. It would therefore be prudent not to precipitate reform in this area nor to expect large near-term fiscal savings from it.

Summary

In sum, Slovakia is engaged in an ambitious reform process which has a potential to quicken productivity growth, increase the employment rate and accelerate the catching-up to the per capita income levels of more advanced OECD countries. Short-term outcomes may be demanding socially and politically, but stimulus to growth and job-creation should help overcome the hardship. Policymakers should fully enforce the new framework for creating and doing business and support it with the full force of law. Human capital enrichment for new entrants through education reform is critical, while intensified re-training for the long-term unemployed is also indispensable, including for the Roma population. Demand for labour will be stimulated by the planned reductions in employment costs in the low end of the market, as well as by the fundamental tax reforms raising the return to enterprise creation and development. Further cuts in social contributions, which remain among the highest among OECD countries, should be a priority. The reform of the public spending system, which is already well engaged, should facilitate such additional cuts and help promote a smaller and more effective government. Continuing efforts of fiscal consolidation will improve the macroeconomic policy mix and help maintain supportive monetary conditions in the face of currency appreciation pressures from EU accession, and will help meet the Maastricht nominal convergence rules on a sustainable basis prior to euro area participation. The nominal flexibility of wages and prices should be conserved in order to preserve the competitiveness of the economy, notably of the domestic manufacturing and service firms. By sticking to this multi-pronged policy agenda, Slovakia would make its growth process more balanced and more job-rich and would accelerate further its already successful catching-up process.

I. Overview of economic trends and policy challenges

Strong growth driven by foreign direct investment

Economic policies in Slovakia were mis-directed during the first years after the country became independent in 1993. In particular, structural reforms were postponed while expansionary fiscal policies propped up domestic consumption and employment and led to substantial deficits in both the government budget and the current account during the mid-1990s. A relatively tight monetary policy, however, prevented inflation from spiralling up. Following the marked change in the government's policy stance in 1998, from one based on state intervention to one which favours pro-market reforms, the initial output and employment costs of harder budget constraints were high. However, the economy rapidly regained its momentum (Table 1, Figure 1), as the macroeconomic policy mix became more balanced and foreign direct investment (FDI) came in on a large scale.

Table 1. **Quarterly gross domestic product**

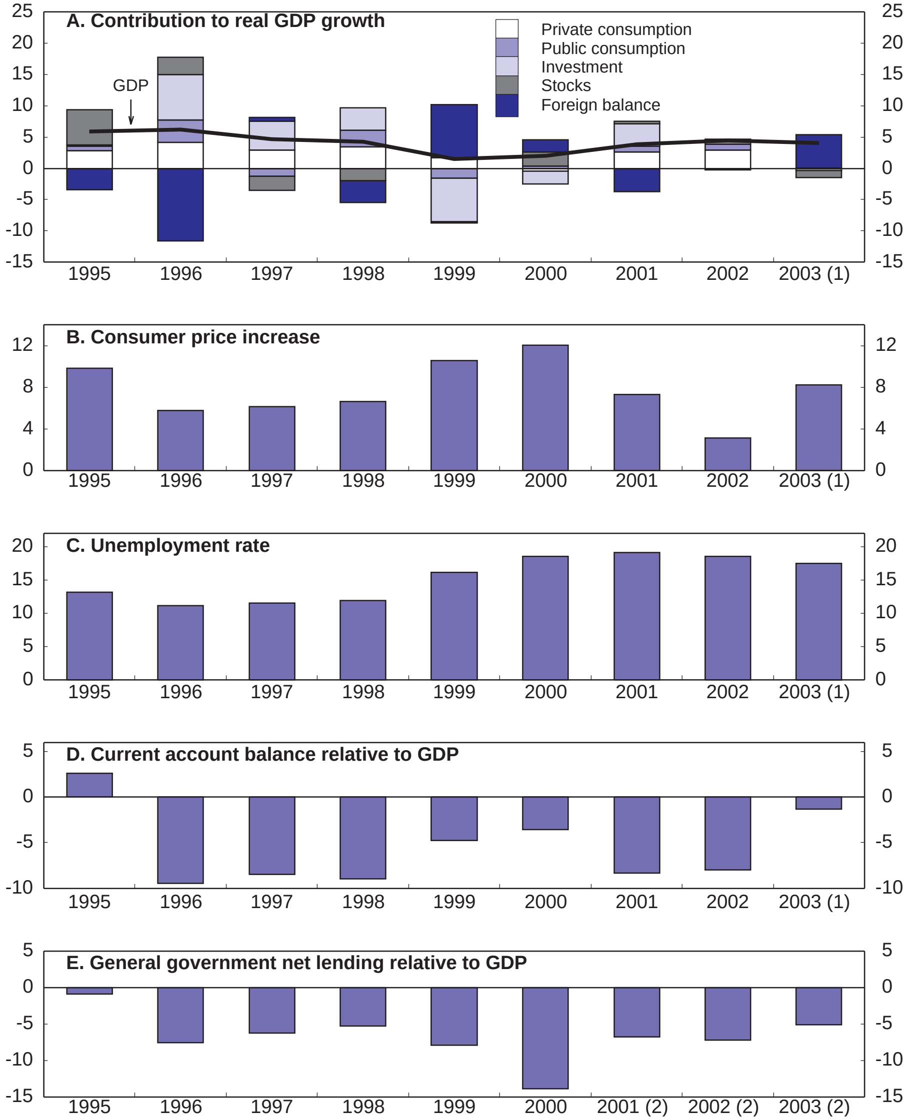
Year-on-year percentage changes at 1995 prices

	2001				2002				2003		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Gross domestic product	3.4	2.9	3.8	5.0	3.9	4.0	4.3	5.3	4.1	3.8	4.2
Households final consumption expenditure	5.1	3.1	5.7	5.1	5.2	6.2	4.8	5.0	2.7	0.2	–2.2
Government consumption expenditure	0.5	6.8	7.9	3.3	7.6	7.4	3.1	1.2	2.0	–3.4	–0.1
Gross fixed capital formation	12.0	14.3	18.6	10.8	–1.7	0.1	–2.0	0.0	–2.4	0.0	–0.7
Change in stocks and net acqu. of valuables	–0.9	0.6	0.3	1.6	–0.6	–0.7	2.5	2.0	–0.1	–2.0	–1.0
Exports of goods and services	12.8	7.6	6.8	–1.5	–4.0	4.6	8.7	12.9	21.0	21.9	22.6
Exports of goods	14.0	8.4	4.6	–2.9	–5.0	4.5	11.4	12.2	25.4	25.6	26.0
Exports of services	7.3	3.8	19.0	6.5	1.2	5.3	–4.5	16.7	–0.5	2.7	3.3
Imports of goods and services	14.9	13.5	14.6	2.0	–4.7	4.6	9.4	11.8	16.5	13.1	13.6
Imports of goods	16.1	14.2	14.9	2.5	–5.9	4.0	8.3	12.2	15.2	14.3	15.2
Imports of services	6.8	9.3	13.0	–1.4	3.8	8.2	16.9	9.6	25.4	4.5	3.1
Net exports	–1.7	–4.4	–5.8	–2.8	0.7	–0.1	–0.9	0.3	3.0	6.4	6.6

Source: Statistical Office of the Slovak Republic.

Figure 1. **Macroeconomic performance**

Per cent



1. Three first quarters.
2. Estimates based on National Accounts.

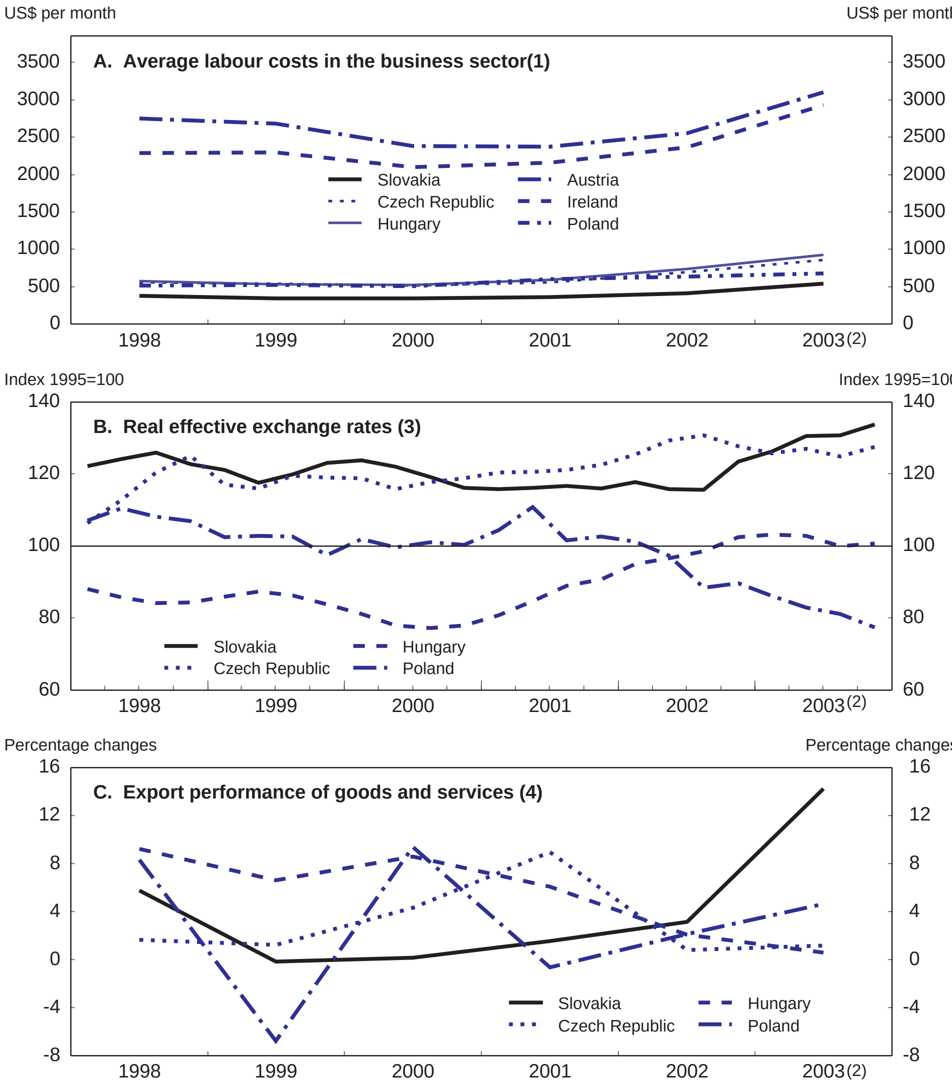
Source: OECD.

A major factor that has drawn foreign investors to Slovakia in recent years is the low labour costs, which in the business sector amount on average to less than a fifth of those in EU countries such as Austria and Ireland. While wage growth has outpaced labour productivity improvements to an extent that unit labour costs increased faster than in other central and eastern European countries over time, a labour cost advantage remains. In combination with the accelerating pace of privatisation and the more FDI-friendly policy environment since 1998, foreign investment picked up markedly and will, in turn, help to boost labour productivity. Indeed, there is wide-spread anecdotal evidence that labour productivity at foreign-invested firms is considerably higher than in domestic Slovak enterprises and in some cases reaches western European levels.[1] Moreover, monetary policy successfully brought down inflationary expectations from the high levels prevailing until the late 1990s and contained the nominal appreciation of the currency within limits that are broadly in line with productivity improvements in the export sector. The low labour costs and FDI-fuelled productivity advances have helped to improve Slovakia's export performance since 2001 amid the international slowdown (Figure 2). This has contributed to Slovakia's recording one of the highest economic growth rates among OECD countries over the past two years, with average annual output increases of more than 4 per cent.

Yet, there remain external pressures on the economy. The recent deterioration in the service balance largely reflects a weakening of energy and other transportation exports that should, however, be only of temporary significance. The trade balance has improved from the very high deficits of 2001 and 2002, but some imbalances may emerge again following a FDI-related upturn in investment and machinery imports. Also, the non-debt creating financing of the current account should not be taken as given, because privatisation inflows are bound to decline (Table 2).

Output is estimated to remain below its potential by the end of 2003. As shown in Figure 3 however, it is difficult to estimate the precise position of the economy *vis-à-vis* its potential. The production sector was not operating under normal market conditions until recently, as it was massively stimulated by government financing and guarantees during the 1995-1998 period. Moreover, an upward inflexion in production capacity has to be taken into consideration because of the momentum of highly productive FDI inflows and ongoing structural reforms (Table 3). To reflect this push, a second estimate of potential output, in addition to the traditional filtering approach, has been made that assumes stronger than historical growth in productive capacity. With these adjustments, the economy appears to operate clearly below potential. The resulting negative output gap is consistent with the weakness of wage pressures in spite of an uptick in inflation in 2003. Also, the persistently low employment rate is an indication of unused supply potential and explains a part of the gap in GDP per capita *vis-à-vis* other OECD countries (Figure 4).

Figure 2. **Export performance improves**



1. Compensation per employee in current $.
2. OECD forecast.
3. Calculated *vis-à-vis* forty-two countries on the basis of unit labour costs for manufacturing. A decline indicates a gain in competitiveness.
4. Calculated as the ratio of export volumes to export market.

Source: OECD.

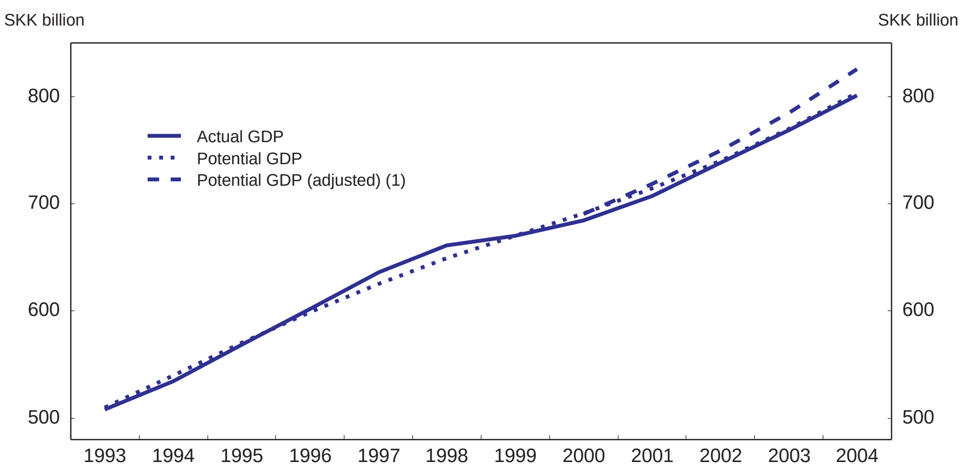
Table 2. **The balance of payments**

US$ million

	1997	1998	1999	2000	2001	2002	2003 Jan.-Aug.
Current account	–1 827	–1 982	–980	–702	–1 746	–1 924	–98
% of GDP	–8.7	–9.0	–4.9	–3.7	–8.8	–8.1	
Trade accounts	–2 081	–2 353	–1 092	–904	–2 125	–2 117	–297
Exports	9 639	10 720	10 229	11 872	12 645	14 382	13 673
Imports	11 720	13 073	11 321	12 777	14 770	16 499	13 970
Services	201	161	218	438	480	456	120
Credit	2 297	2 436	2 063	2 245	2 490	2 786	2 086
Debit	2 096	2 275	1 845	1 807	2 010	2 330	1 966
Income	–122	–157	–301	–353	–313	–456	–102
Credit	316	438	267	269	322	343	647
Debit	437	595	568	622	634	800	749
Current transfers	175	367	196	118	212	193	181
Credit	543	646	465	344	500	476	348
Debit	368	279	269	227	288	282	167
Capital and financial account	1 862	2 053	1 924	1 320	1 801	5 217	566
Capital account	0	70	160	92	78	107	75
Financial account	1 862	1 983	1 764	1 228	1 723	5 109	491
Direct investment	125	537	761	1 904	1 542	4 049	389
Portfolio investment	25	793	623	819	–229	553	–531
Other investment	1 712	652	380	–1 496	398	507	640
Errors and omissions	–12	–621	–224	206	89	353	–137
Overall balance	–12	–550	721	824	143	3 646	605
% of GDP	–0.1	–2.5	3.6	4.3	0.7	15.4	

Source: National Bank of Slovakia.

Figure 3. **Potential growth and output gap**



Note: Estimates based on 1995-prices.
1. Re-estimation of potential output, assuming an acceleration of trend growth as a result of structural reforms.
Source: OECD.

Table 3. **Gross domestic product by sector**

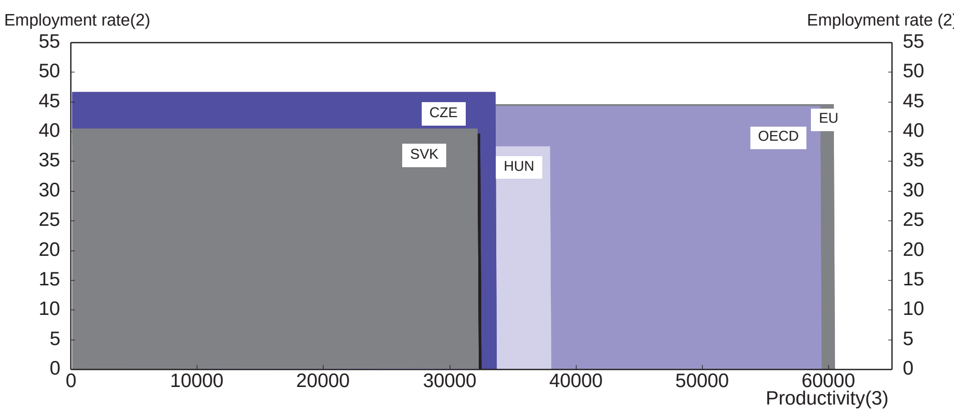
Per cent

	1996	1998	2000	2002
Agriculture	5.1	5.4	5.2	5.1
Industry (except construction)	30.4	27.0	25.9	25.9
Construction	6.7	5.1	3.5	3.6
Trade, hotels and restaurants; transport, storage, post and telecommunications	21.8	23.6	25.3	24.2
Financial intermediation and other business activities	12.7	14.7	16.4	16.8
Public administration and defense; education; health, social work; other community service activities	15.3	15.4	14.8	16.1
Value-added tax, excise taxes, import taxes and subsidies	8.0	8.8	8.9	8.3
GDP (euros million)	14 856	17 860	19 420	23 055

Source: Statistical Office of the Slovak Republic and Eurostat.

Figure 4. **The two determinants of GDP per capita**[1]

2002



1. The surface for each country represents its GDP per capita.
2. Employment over population in per cent.
3. GDP per employed person in current prices using PPPs, US$.

Source: OECD.

Low employment, high unemployment

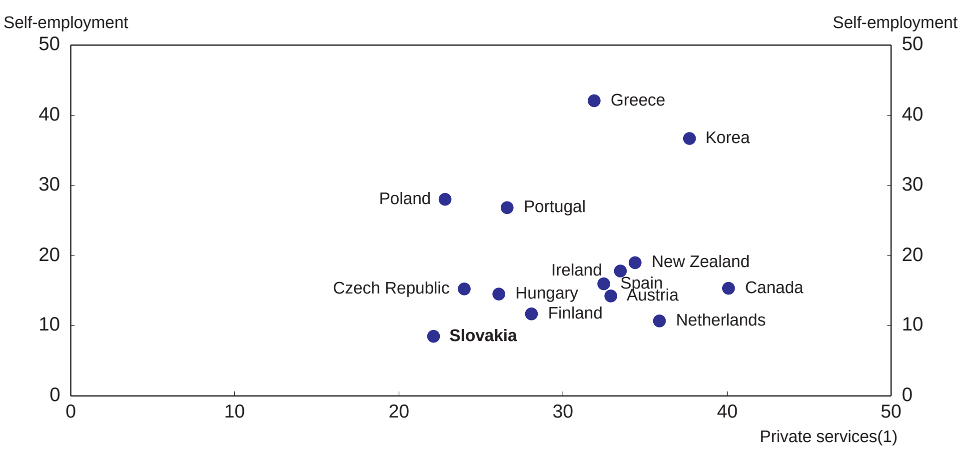
While the activity rate of the Slovak population aged 15-64 years is a respectable 70 per cent, slightly exceeding the EU average, the employment rate is as much as 7 percentage points below the EU average because of high unemployment. The employment rate, at 57 per cent, is one of the lowest observed in OECD countries. Moreover, the pattern of employment is skewed towards the public sector, with the general government accounting for over one-fifth of existing jobs, representing one of the largest government sectors in OECD countries.

The share of the low-skilled in unemployment increased from 8 to 23 per cent from 1994 to 2002. This shows that the growth process has not been able to redirect those losing their jobs in transition restructurings into productive use, reflecting both insufficient demand for and weak effective supply of labour in the lower segment of the market. In other OECD countries many low-skilled workers are successfully employed in private services, as salaried employees or self-employed, while these types of activities remain under-developed in Slovakia (Figure 5).

Slovakia's inability to generate jobs for marginal workers has not improved in the recent period. Almost a quarter million low-skilled jobs requiring no more than primary or incomplete secondary schooling disappeared during 1994-2002, and their share in total employment plummeted from 20 to 8 per cent. Punitive rates of social security contributions played a role in pricing such workers out of the market while the welfare system imposed prohibitive marginal tax rates on the benefit recipients accepting low-wage jobs (Box 1).

Figure 5. **Private services and self employment**

In per cent of total employment, 2001



1. Include wholesale and retail trade, hotels and restaurants, financial intermediation and real estate renting and business activities.

Source: OECD.

Box 1. Long-term unemployment driven by supply or demand?

Who are the long-term unemployed? According to labour force surveys, more than three-fifths of Slovak jobless have been unemployed for more than a year. The majority of them are characterized by low educational achievement. At least one-third of the long-term unemployed are of the Roma ethnic origin, giving the long-term unemployment an ethno-cultural dimension (Box 15 in Chapter IV).

Why do so many low-skilled persons remain unemployed? *Labour supply-side* explanations emphasise weak work incentives that penalise the unemployed moving to low-wage jobs. Although unemployment benefits are of short duration, generous welfare benefits have been available to the long term unemployed. From both an ethical and legal point of view, the welfare system has been massively abused by healthy working-age unemployed. From an economic point of view, the "abusers" have behaved rationally basing work decisions on a comparison of costs and benefits. The most rewarding option for them has been to combine welfare benefits with an undeclared job.*

Labour demand-side explanations focus on high social-security contribution costs. Until recently, these have exceeded 50 per cent of gross wages and, as they are capped for high salaries, penalise low-skilled workers more than others. They help explain the rapid diffusion of labour-saving technologies, in traditional farming and manufacturing, as well as in services. Ethnic prejudices also shift the labour-demand schedule downward for the Romani low-skilled workers, more particularly in the "interaction-intensive" services such as hotels, restaurants and domestic help.

In principle, low-skilled workers should find employment opportunities in low-wage service firms to emerge around clusters of highly-productive FDI plants in western and eastern Slovakia, and in the large FDI-centred agglomerations in neighbouring Hungary or the Czech Republic. Both of these countries have significantly higher levels of FDI stock and low-wage job vacancies than Slovakia. Due to a joint Czech-Slovak labour market agreement and the prospective abolition of current restrictions on employment of Slovaks in Hungary in 2004 when these countries join the EU, more Slovak job seekers should be able to find employment in these countries.

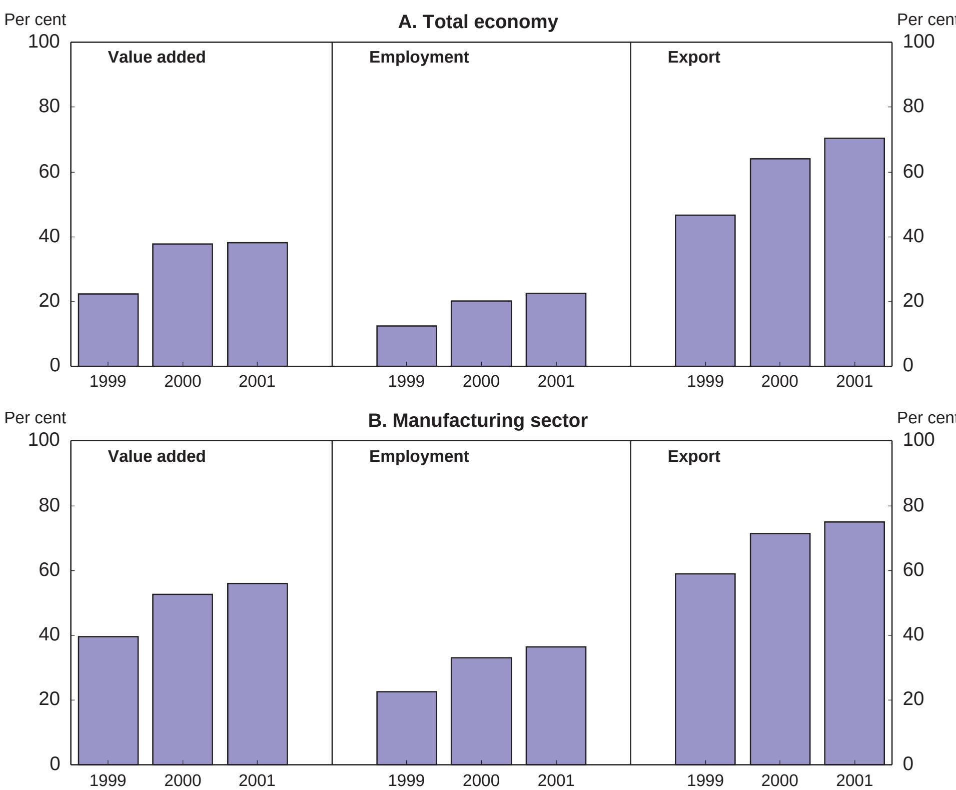
To tackle long-term unemployment domestically, both supply- and demand-side measures are necessary and legislation addressing the underlying problems is in an advanced stage of adoption. As work incentives for marginal workers are too weak, the ongoing changes in the way in which welfare benefits are granted to able-bodied citizens should encourage the unemployed to move out of passive welfare dependence (see Chapter IV below). The planned employment subsidies in the high-unemployment regions should also help. In addition, a tax-regime more favourable to entrepreneurship, which is being introduced, should provide additional incentives for business and job creation in the private sector.

* Government estimates based on ILO methodology point to a stock of 150 000 individuals in hidden employment, implying that a significant fraction of the unemployed welfare recipients may indeed be working, albeit illegally.

The dual economy and the lagging sector

As other post-transition economies, Slovakia experiences distinct productivity and human capital gaps between a highly performing FDI sector and generally lagging domestic and state-owned businesses (Figure 6). At the same time, it appears more flexible than neighbouring economies in accommodating this duality, because it seems able to sustain a wider dispersion of wage and profitability levels. Data on payment discipline and bankruptcy risk, however, suggest that the performance gap between the two sectors may be further widening. If this leads to wage and profitability aspirations shifting upward throughout the economy, such pressures would make the survival of lower-productivity firms more difficult. At

Figure 6. **The growing share of the FDI sector**
Percentage share of foreign affiliates



Source: Statistical Office of the Slovak Republic.

the same time, acting in the opposite direction, the growth of well-performing firms that are distributing healthy profits and salaries should create indirect demand for private services and opportunities for lower-skilled self-employment.

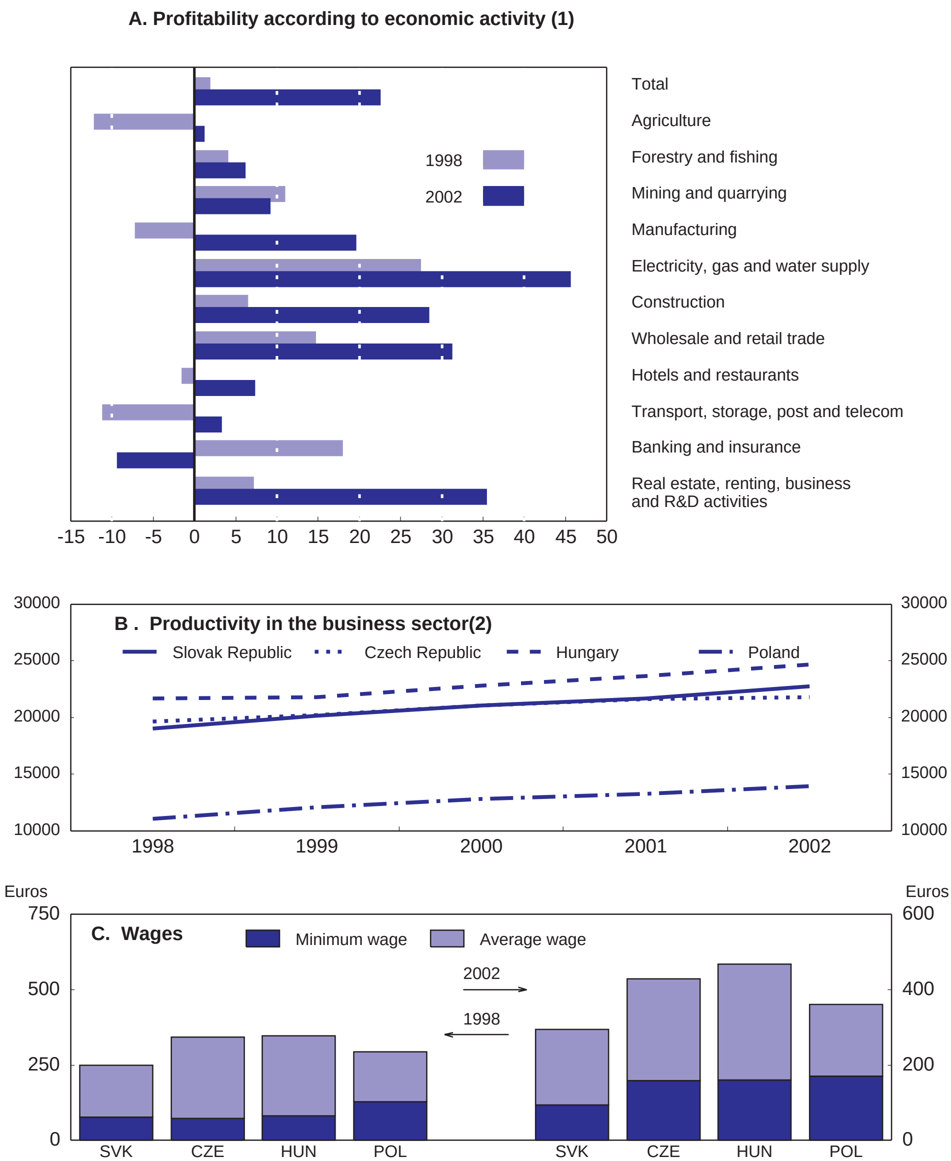
The productivity gap in the domestic sector is most clearly reflected in the poor performance of agriculture and mining where domestic ownership predominates (Figure 7). Similarly, in the transport and telecommunications sector, the heavy losses of the state-owned railways reduce sectoral profitability. In the financial services sector, the profitability of the commercial banks improved after the take-over of the majority of domestic banks by foreign investors and the negative balance for the banking and insurance sectors in 2002 was entirely due to the substantial losses of the Central Bank.

Although aggregate profitability of industry has recovered remarkably since the opening of the economy to foreign investment and the imposition of hard-budget constraints on domestic firms, the wide dispersion of profitability persists. The share of labour in value added varies according to sectors (Figure 8) and remains in general lower than in the more advanced OECD countries. Against this background, foreign-invested firms outperform domestically controlled counterparts in profitability (Table 4). Available data on firms' creditworthiness confirm a tendency towards polarisation, showing that the number of firms on both ends of the spectrum keeps increasing. Endangered firms now account for an increasing share of a large panel of enterprises.[2] Keeping such lower-productivity firms viable under overall cost increases is increasingly challenging.

Low-profitability Slovak firms compensate for their weaker performance by paying lower wages and by saving on training and other investments, when compared to the foreign-controlled sector. This has helped reduce their total labour costs in the recent past (Table 5). This cost-minimising response is better than plain exit in the short-run, yet sub-par human capital investment implies that such firms risk falling further behind and becoming even less competitive in the future. Notably, those operating in trade-exposed sectors are likely to face more intense competition from low wage countries and may not withstand this competition unless they succeed in differentiating their products. Taking into account these pressures and factoring in the excess employment hidden in state-owned corporations and in the general government sector, vulnerable job positions might presently account for a significant share of total employment.[3] Slovakia will need to create additional jobs not only for the currently unemployed, but also for this fringe of workers who could lose their jobs in the foreseeable future. The challenge on this front is therefore formidable.

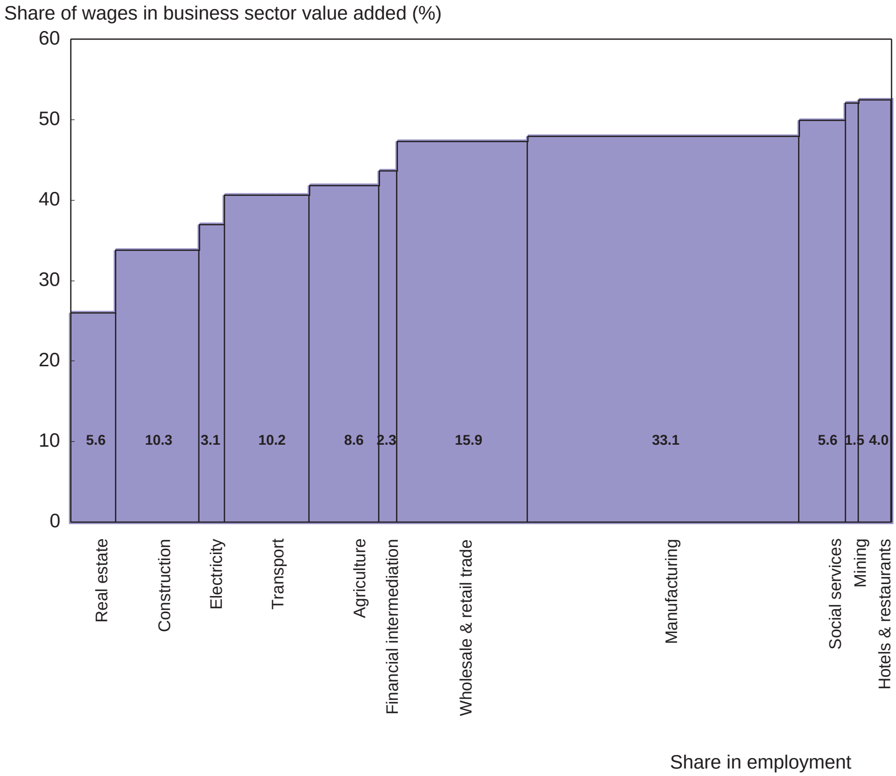
Overall, the country continues to enjoy a remarkable labour cost advantage. Average wages have remained lower than in other EU accession countries in the region. Following an uptick in 2002 due to unexpectedly rapid disinflation,

Figure 7. **Profitability by sector**



1. Profit to net production ratio.
2. Business sector output per employee, in US$ at PPP.
Source: Eurostat, Statistical Office of the Slovak Republic and OECD.

Figure 8. **Cumulative distribution of employment by wage share in value-added, 2000**



Source: Statistical Office of the Slovak Republic.

real wage growth decelerated again in 2003. Yet, the danger of wage spillovers from the FDI sector remains a threat. The rapid wage growth that has taken place in the neighbouring Hungary and the Czech Republic, mostly via accelerated public sector wage growth, shows that this risk should not be underestimated. The previous government, in power from 1998 to 2002, pursued a policy of raising the minimum wage in order to improve work incentives but this approach did not succeed as work motivations were eroded by the welfare system (Table 6). The current administration is aware of the pitfalls of this policy and pursues a more cautious minimum wage policy in order to increase the employment chances of the low-skilled, the viability of the struggling firms and the incentives for new job-creation.[4]

Table 4. **Profitable *versus* loss-making non-financial corporations**[1]

	Profitable corporations			Loss-making corporations		
	2000	2001	2002	2000	2001	2002
Employees[2]						
in national-private firms	69.1	74.4	77.7	30.9	25.6	22.3
in state-owned firms	51.5	79.8	56.2	48.5	20.2	43.8
in foreign-controlled firms	68.6	66.6	73.1	31.4	33.4	26.9
in multinational firms	80.7	88.5	90.5	19.3	11.5	9.5
Average monthly wage in SKK thousand	12.7	14.2	15.2	11.8	12.1	13.3
in national-private firms	12.1	12.9	13.7	11.1	11.4	12.4
in state-owned firms	13.0	14.7	16.8	13.2	14.1	14.7
in foreign-controlled firms	15.3	16.6	16.9	13.9	14.1	15.8
in multinational firms	16.1	19.1	20.2	13.2	13.1	15.8
Pre-tax profits in SKK million	79.8	124.0	127.4	–31.4	–25.5	–31.9

1. Non-financial corporations with at least 20 employees.
2. In per cent of total employment in each type of firm.
Source: Statistical Office of the Slovak Republic.

Table 5. **Total labour costs by form of ownership**

Costs per hour

	2000	2001	2002	2000	2001	2002
	SKK			Percentage changes		
Ownership form						
Private	125.14	121.20	139.54	9.5	–3.1	15.1
Co-operative	89.10	92.54	106.51	8.0	3.9	15.1
State	112.51	123.07	146.75	2.0	9.4	19.2
Municipal	111.15	135.62	120.25	6.6	22.0	–11.3
Foreign	146.91	172.45	182.31	19.4	17.4	5.7
International	163.87	197.53	194.17	20.6	20.5	–1.7
Other[1]	96.12	99.47	126.83	2.4	3.5	27.5
Average	119.50	128.86	145.65	7.0	7.8	13

1. Associations, churches, political parties.
Source: Statistical Office of the Slovak Republic.

Recent microeconomic and institutional reforms and the alignment to the *acquis communautaire* should continue to support business start-ups, job creation and self-employment, including in new and smaller-sized service activities. Paradoxically, while the subsidiaries of FDI firms have easier and direct access to the critical resources for their development such as finance, technology, customized infrastructures and protection of their property rights via political and judicial actions, smaller firms need to rely on the formal legal and infrastructural framework of the economy. They are more vulnerable to failures in law and rule enforcement, and to instances

Table 6. **Wage developments**
Annual growth rate in per cent

	1994-97	1998	1999	2000	2001	2002	2003[1]
Overall nominal wage	13.6	9.6	7.2	6.5	8.2	9.3	6.5
Business sector	15.1	10.1	8.9	11.3	9.5	7.6	5.5
Non-business sector	13.9	8.6	3.3	2.1	7.1	16.0	10.2
Overall real wage	5.5	2.8	–3.1	–4.9	0.8	5.8	–1.0
Business sector	6.6	3.3	–1.4	–0.3	2.4	4.2	–2.0
Non-business sector	5.8	1.9	–6.4	–8.5	0.1	12.3	2.4
Productivity[2]	4.9	4.4	3.6	2.8	1.8	4.3	3.1
Memorandum items:							
Relative wages (%)							
Business sector/non-business sector	112.3	115.7	122.0	133.0	136.0	126.3	111.9
Minimum/average	33.9	30.0	33.6	38.5	39.8	41.2	42.6

1. Data refer to the 1st quarter.
2. Real GDP per employee.
Source: Statistical Office of the Slovak Republic; Ministry of Labour, Social Affairs and the Family.

of corruption and favouritism in the judiciary, in competition policies and in sectoral regulations. There is a need for efficient and publicly available transportation and communications infrastructure, effective competition policies against predatory actions of incumbents, and strong protection of intellectual and other property rights by the court system (Chapter IV).

The outlook

Four major reforms approved in 2003 and effective as of January 2004 are likely to have a significant positive impact on trend growth.

– First, the tax reform is cutting the income tax rate on both wages and profits to 19 per cent, eliminates taxation of dividends and creates strong incentives for business creation and self-employment.

– Second, the pension reform increases the effective retirement age to 62, modernising the PAYG pillar and aiming at introducing a capitalised second component.

– Third, bold labour market and welfare reforms raise the incentives to find work and thus are conducive to raising the employment rate.

– Fourth, the overhaul of the wasteful sickness benefit scheme and the introduction of co-payments in the public healthcare system permit a reduction in punitive non-wage labour costs.

Box 2. Three growth scenarios

According to Secretariat calculations, Slovak productivity measured by per worker GDP in purchasing power parities reached 42 per cent of the US level in 2002. GDP growth and the productivity catch-up to the most advanced OECD economies will likely continue over the medium term, but the speed of narrowing the existing gap depends crucially on the extent to which the government's reform proposals are implemented. Three scenarios may serve to show different possible growth paths, as a matter of illustration, rather than a forecast:

– a scenario (I) that is confident about the government's capacity to implement the reforms, but remains conservative in the sense that it allows for some potential delays and amendments. This is consistent with the current OECD medium-term reference scenario;

– a scenario (II) that is pessimistic about the government's ability to implement the reform package;

– a scenario (III) that assumes that all reforms will be enacted as proposed.

The OECD medium-term reference scenario (I) indicates that the catch-up will continue rapidly, with output growth exceeding 4 per cent per annum. This is consistent with labour productivity growth of 3½ per cent per annum and a gradual increase in the employment rate from the current 56½ per cent to almost 62 per cent by 2009. Employment would grow by 7½ percentage points over the same time period. With gradual increases in the low statutory retirement age implied by the pension reform, participation rates of the older cohorts (55-59, 60-64) are very likely to increase, driving the overall activity rate up. The unemployment rate would decline by 2009 to below 14 per cent.

In the second scenario (II), planned spending cuts, fiscal consolidation and structural reforms are not implemented. The consequent higher taxes and labour costs, interest rates and resulting real appreciation of the currency would significantly increase pressure on many low-productivity, domestically-controlled firms, accentuating the duality in the business sector and resulting in job losses. Accelerated exit of marginal firms would result in faster productivity growth but lost jobs would not be replaced.[1] The unemployment rate may then reach 21 per cent in 2009, and GDP growth would fall short of that achieved in scenario (I).

In the third scenario (III), the radical labour market and welfare reforms undertaken by the government and endorsed by this *Survey* are fully implemented and result in an activation of many long-term unemployed and their rising placement in low-wage jobs. This would result in total employment growing almost twice as fast as in the baseline scenario but average productivity would be lower.[2] The employment rate would increase over the 6 years to about 64 per cent, a significant increase but to a level that would still be below the rates observed recently in small OECD economies such as the Czech Republic (65 per cent), Finland (68 per cent) or Portugal (73 per cent). The unemployment rate would fall to 10½ per cent. Real GDP per capita achieves a clearly superior performance.

Box 2. **Three growth scenarios** (*cont.*)

Three scenarios

	Employment growth (%)			Productivity growth (%)			Real GDP growth (%)		
Scenario	I	II	III	I	II	III	I	II	III
2004	0.9	0.0	1.8	3.2	4.7	3.2	4.2	4.7	5.0
2005	1.1	0.0	1.9	3.2	4.5	3.1	4.4	4.5	5.0
2006	1.3	0.0	2.0	3.5	4.4	3.1	4.8	4.4	5.1
2007	1.4	0.0	2.1	3.6	4.2	3.0	5.1	4.2	5.1
2008	1.4	0.0	2.2	3.6	4.1	3.0	5.1	4.1	5.2
2009	1.4	0.0	2.3	3.6	4.0	2.9	5.1	4.0	5.3

Source: OECD.

1. Two alternative productivity catch-ups were estimated with the aid of the following model that measures labour productivity with by GDP per worker:
$S(t) = (1 + \alpha)\cdot S(t-1) + \beta\cdot[A(t-1) - S(t-1)]$,
where S and A denote productivity in Slovakia and the United States respectively, α is the trend growth rate of productivity of 1½ per cent per annum, t indexes time and β refers to a specific catch-up parameter. In this accelerated productivity scenario, the catch-up parameter is set to 2½ per cent. In the following scenario III with lower productivity growth, it is set to 1¼ per cent.
2. The literature on the demand elasticity of employment to total labour costs points to a large range of estimates. According to one source, elasticity estimates range from –0.15 to –0.75 depending on economic and market structures. Taking into account the weight of cost-sensitive foreign direct investment and domestic export-oriented activities in the economy, this elasticity, which has never been estimated for Slovakia, should be on the higher end. See Hamermesh (1993), and Fajnzylber and Maloney (2001).

These reforms are being implemented in the context of an improving macroeconomic policy mix, with progress in fiscal consolidation and successful containment of currency appreciation through lower interest rates. These developments are expected to accelerate the mobilisation of labour resources and re-activate investment and should boost the trend output growth (Box 2).

Policy challenges

The Slovak economy has achieved strong output growth, rising employment and falling unemployment since the previous *Survey* a year and a half ago,[5] despite delayed recovery in Western Europe and a slowdown in domestic demand in 2003. Exports have driven output growth as many FDI projects came to completion and high levels of capacity utilisation have been achieved. Slovakia continues to attract large as well as small FDI projects and is the most rapidly growing economy in Central Europe. Integration into the EU in the wake of the accession scheduled for May 2004 is expected to reinforce this trend.

The new government aims at attaining the Maastricht monetary and fiscal criteria as early as 2006, but the policy mix still remains unbalanced, despite recent progress, with a large budget deficit and tight monetary conditions. A better balanced macroeconomic policy mix would help broaden the basis of growth through two channels. First, it would allow more supportive monetary conditions for businesses through lower real interest and exchange rates than otherwise. Second, fiscal consolidation through expenditure prioritisation would result in growth-enhancing structural changes in public spending. The challenge for monetary policy will be to navigate on a narrow path avoiding the appreciation pressures from long and short-term capital inflows, which are bound to increase with EU integration and the pursuit of successful competitiveness and growth strategies. The challenge for fiscal policy is to guard against possible revenue shortfalls from the envisaged tax reforms, impose spending discipline and ensure continued reduction in the fiscal deficit. These macroeconomic policy challenges are discussed in Chapter II.

A bold strategy to reform public expenditures has already been outlined. The new government that came into office in 2002 embarked on a fiscal consolidation to curb the large budget deficits resulting partly from past policies. The authorities have stated their intention to reduce the general government deficit by more than one percentage point of GDP per annum until 2006 to reach the Maastricht target. This ambitious aim is to be achieved mainly through expenditure cuts. The major challenges to this strategy pertain to the necessary mapping-out of strategic spending priorities and to the need to counter spending slippages, notably concerning health care, public sector wages and decentralisation-related spending. These public expenditure issues are addressed in Chapter III.

FDI-led growth coexists with one of the lowest employment rates in the OECD area. The growth path to date has not generated adequate jobs in sufficient numbers to engage low-skilled people in productive activity. As a consequence, a large number of low-skilled adults are trapped in long-term unemployment and a number of them, with obsolete skills, have left the labour force with the risk that they will never return. Unless the recently introduced structural reforms are successful, the ongoing growth pattern may exacerbate this situation by weakening labour supply and demand in the low end of the labour market. There is potential to create lower skill jobs in larger numbers in services and self-employment. Pursuing the microeconomic liberalisation and institutional reforms already under way to facilitate firm creation throughout the territory would help increase the employment rate. The ongoing tax and regulatory reforms would encourage such a development by rewarding small-size entrepreneurship on a par with large corporations. Similarly, the new framework for business-facilitation appears supportive of small businesses in the areas of company registration, collateral registration, public procurement, competition policy and infrastructure provision. The challenge in this context is to make this regulatory framework fully enforceable in order to make growth more job-rich, as discussed in Chapter IV.

II. Macroeconomic policies

A responsive monetary policy and the beginning of fiscal consolidation have helped to improve macroeconomic balances during 2002 and in the course of 2003. The National Bank of Slovakia (NBS) has successfully pursued its disinflation objectives over the period under review and managed to avoid a sharp appreciation of the currency in the face of large-scale capital inflows. On the fiscal side, the overdue consolidation of public finances has started, and the very large deficit of 2002 is being reined in. Yet, the heavy burden of government guarantees and soft loans from earlier years limits the government's ability to restructure its expenditures and to increase much-needed investments in human resource and physical infrastructure development and maintenance. Overall, the macroeconomic policy mix remains still unbalanced with a sizable fiscal deficit and monetary conditions, which have consequently had to remain tight, but the authorities have endeavoured to chart their convergence course towards the Maastricht criteria and this has helped the country to earn upgrades on its long-term sovereign debt from international rating agencies.

Monetary and exchange rate policy

Since a modified institutional framework for monetary policy took effect in July 2001, the NBS has tried to pursue the two policy objectives of medium-term price stability and currency stability. The annual policy strategy to achieve these objectives is laid out in the Bank's Monetary Programme, which is published in the second half of the preceding year and updated to reflect changes in the economic environment at the beginning of the concurrent year. In the context of projected developments in administrative prices, wages and fiscal policy, the programme spells out the expected short and medium term evolution of key macroeconomic variables, such as inflation, output growth and employment. The Monetary Programme also contains an exchange rate target range *vis-à-vis* the euro, but this range is not disclosed.

Disinflation continues

Both headline and core inflation rates in 2002 were lower than envisaged in the Bank's Monetary Programme (Table 7). Core inflation, which excludes

Table 7. **Monetary programme of the National Bank of Slovakia**

A. Programme and outcomes 2001-2003

	2001 Programme	2001 Outcome	2002 Programme	2002 Outcome	2003 Programme	2003 Updated Programme
Headline inflation[1]	6.7 – 8.2	6.5	3.5 – 4.9	3.4	7.7 – 9.7	8.4 – 9.7
Core inflation[1]	3.6 – 5.3	3.2	1.9 – 2.2	1.9	2.7 – 5.0	2.1 – 3.6
Real GDP growth	2.8 – 3.2	3.3	3.5 – 3.8	4.4	3.7 – 4.1	3.9 – 4.4
Current account balance[2]	–4.0	–8.6	–7.9	–8.4	–6.2	–4.5
Fiscal deficit[2]				7.2	5.0	4.9

B. Medium-term Programme 2004-2006

	2004	2005	2006
Headline inflation[1]	6.8	2.8	2.5
Core inflation[1]	2.4	1.9	2.2
Real GDP growth	4.2	4.4	4.6
Current account balance[2]	–4.8	–4.4	–3.3
Fiscal deficit[2]	4.0	3.4	3.0

1. End of year figures.
2. Per cent of GDP.
Source: National Bank of Slovakia.

administered price changes, amounted to 1.9 per cent compared with a target range of 3.2 to 4.7 per cent, and headline inflation came out at 3.4 per cent against a target of 3.6 to 4.2 per cent. This lower-than-projected inflation was mainly due to unexpectedly low domestic prices for non-processed food products, weak world oil prices, and the strengthening of the Slovak Koruna against the US Dollar towards the end of the year with its moderating effect on import prices. The undershooting of the inflation target, which occurred also in 2001, increased real wages and interest rates beyond expectations. This has prompted the NBS to further refine its inflation forecasting.

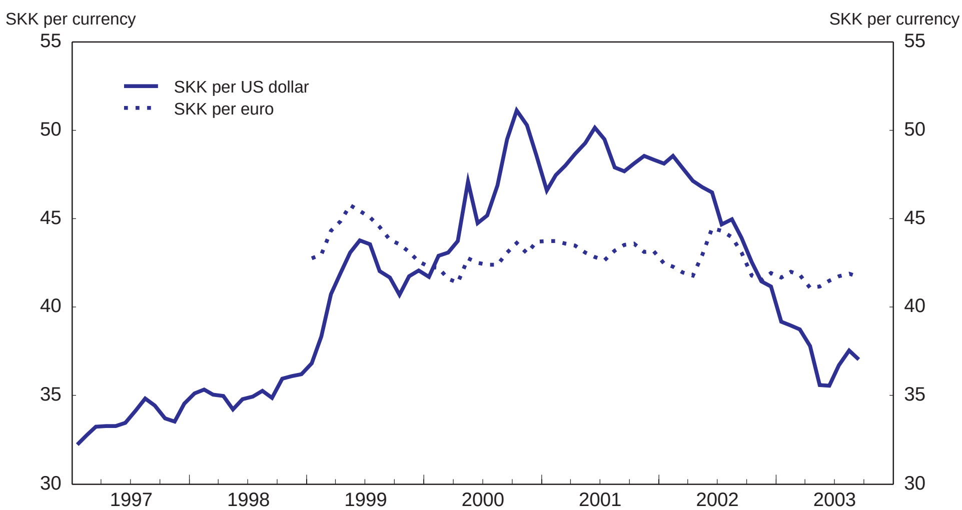
For 2003, the NBS expected increased inflationary pressures as a result of the introduction of higher excise taxes, changes in VAT rates, and increases in regulated prices for transport, utilities and housing. Core inflation is projected to be in the 2.1 to 3.6 per cent range, and headline inflation about 8.4 to 9.7 per cent. By the end of August, core inflation stood at 2.7 per cent on a year-on-year basis, and headline inflation at 9.2 per cent, so that inflation outcomes during the first eight months of the year are in line with the targets set out in the Monetary Policy Programme. A monetary policy challenge, however, will be to contain possible second round effects of the upward adjustments of regulated energy prices in the first half of 2004.

Appreciation pressure on the koruna has been contained

The Bank's aim to reduce inflation has been helped by the strength of the Slovak koruna. Between the election of the government in September 2002 and September 2003, the koruna has appreciated by 3 per cent against the Euro and by 15 per cent against the US Dollar (Figure 9). The real effective exchange rate strengthened by 14 per cent over the period. The NBS has tried to actively manage and keep the exchange rate on a smooth path in the context of large-scale capital inflows following the election outcome that was favourable to international integration and the related upgrade of investor confidence. The objective has been to allow a modest appreciation of the koruna in line with productivity gains, but to avoid large currency swings and a sharp appreciation that could undermine competitiveness and create risks for macroeconomic policy management.

The pressure on the koruna was particularly strong during October and November 2002 and in May 2003. A reduction in the two-week repo rate, the Bank's main policy interest rate, by 25 basis points in October 2002 and several days of massive interventions worth € 500 million did not ease the pressure on the currency. This led to a further 150 basis points cut in policy interest rates on 18 November 2002. The two-week repo rate was lowered to 6.5 per cent, while the overnight sterilising repo rate and the refinancing rate were

Figure 9. **Nominal exchange rates**



Source: OECD.

reduced to 5 per cent and 8 per cent respectively. Subsequently, the NBS has continued to intervene in foreign exchange markets on an occasional basis, and even took recourse to somewhat unorthodox monetary policy instruments to halt the inflow of portfolio investment on 5 May 2003, when it imposed a temporary cap on the size of its deposit-taking activity, forcing banks to place funds at less well remunerated overnight facilities. More recently, on 25 September, the NBS lowered its policy interest rates by 25 basis points, as domestic inflation pressure had been diminishing. The monetary policy actions of the Bank have been accompanied by a communication strategy that, in combination with the dominant role that the NBS plays in the relatively small Slovak currency market, has been effective in supporting the Bank's objectives. Yet, while the combination of interest rate cuts, foreign exchange market interventions and *ad-hoc* measures has been successful in avoiding a sharp appreciation in the nominal exchange rate, the interventions and related sterilisation of capital inflows have come at a cost to the NBS. In 2002, the deficit of the Bank, as a result of its foreign exchange losses and the interest costs of sterilisation operations, amounted to SKK 24.8 billion, or 2.3 per cent of GDP. This is the first annual loss of NBS since its establishment in 1993 and a loss of similar size is expected for 2003.[6]

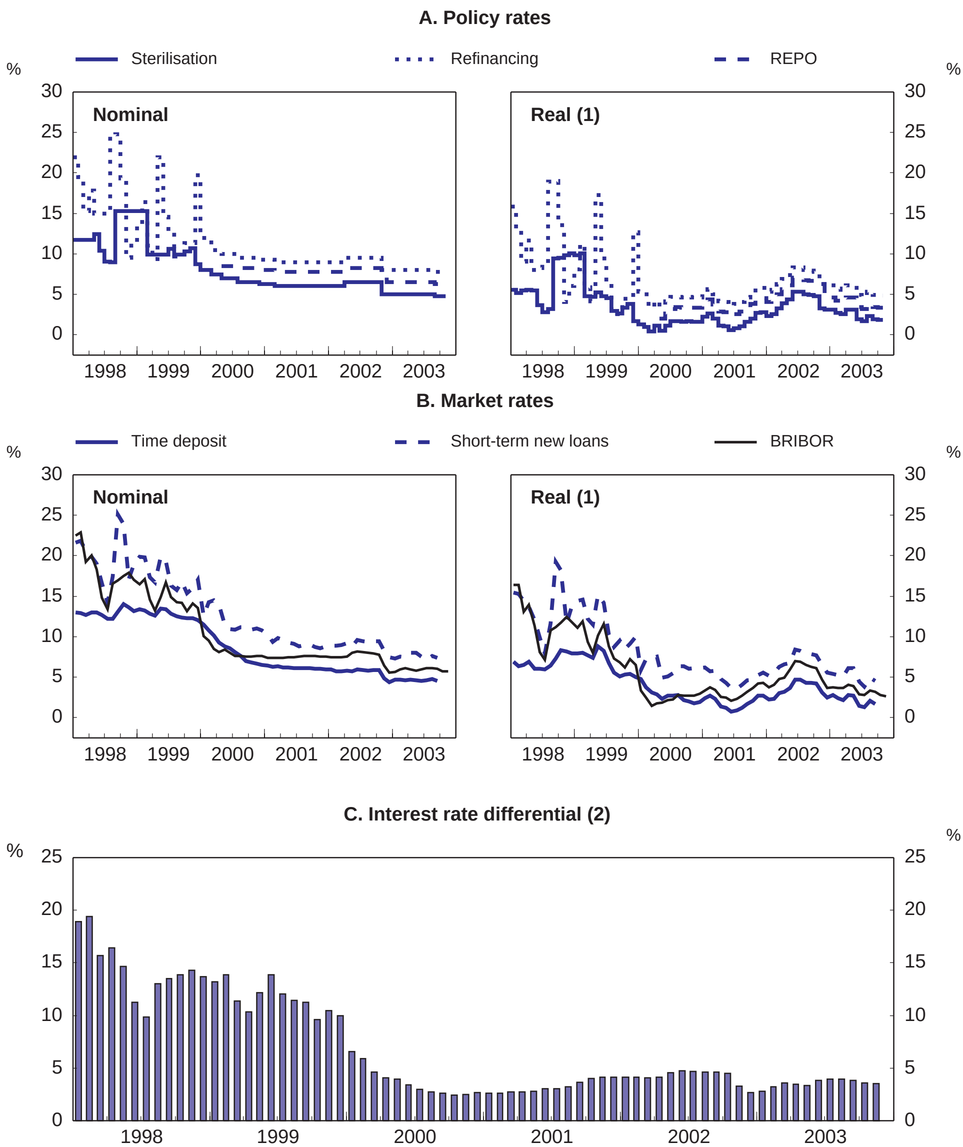
Slovakia remains attractive for portfolio investors

The development of commercial nominal interest rates has mirrored the path of the policy interest rates, with a sharp drop in November 2002 and a flat pattern thereafter (Figure 10). Low real interest rates, together with more vigorous competition among banks following restructuring, contributed to a marked increase in loans to households, by 18 per cent during 2002 and 12 per cent during the first half of 2003. However, loans to households concern mostly mortgages, and credits from building societies, and still account for less than 10 per cent of M2 (Table 8), so that the inflationary risks from rapid credit expansion seem limited. Also, the surge in housing-related credit in the first half of 2003 seems to have occurred partly in anticipation of a reduction in government support for residential construction activities in July 2003, so that the credit expansion is likely to remain temporary. Domestic credit to businesses remains subdued, as the large and rapidly growing FDI-firms continue to be funded mainly from international sources.

The cuts in the key policy interest rate in October and November 2002 narrowed the policy rate spread *vis-à-vis* the euro area to 3.25 per cent, but subsequent interest rate reductions by the European Central Bank had again widened the differential to 4.5 per cent by March 2003, before it narrowed slightly to 4.25 per cent following the NBS' rate cut in September 2003. These relatively

Figure 10. **Interest rate developments**

Year-on-year percentage changes



1. Deflated by core inflation.
2. Between three-month BRIBOR and EURIBOR (FIBOR before 1999).

Source: National Bank of Slovakia.

Table 8. **Money and credit**
End of period growth rates

	1999	2000	2001	2002	2003 October
Money supply					
M1	4.6	21.6	22.1	7.7	16.2
Currency	15.5	16.5	20.9	4.0	10.9
Demand deposits	–1.0	24.7	22.7	9.8	19.2
Quasi-money	15.9	12.1	9.1	3.5	0.4
Time deposits	15.4	10.0	6.1	1.1	5.2
Foreign currency deposits	17.9	20.4	20.0	11.4	–13.9
M2	12.3	14.9	13.1	4.9	5.5
Domestic credit	6.6	8.6	13.9	9.1	9.8
Net credit to government[1]	9.2	20.9	25.2	15.2	13.5
Credit to households and entreprises[1]	5.4	4.1	6.3	9.1	8.2
Credit in foreign currency	27.1	–6.7	14.4	9.6	21.8
Memorandum items:					
Nominal GDP growth	7.8	8.7	8.9	8.5	
Income velocity GDP/M1	5.4	4.9	4.3	4.4	
Income velocity GDP/M2	1.6	1.5	1.5	1.5	

1. Series adjusted for issues of restructuring bonds and balance-sheet adjustments of closing and restructuring banks.
Source: National Bank of Slovakia.

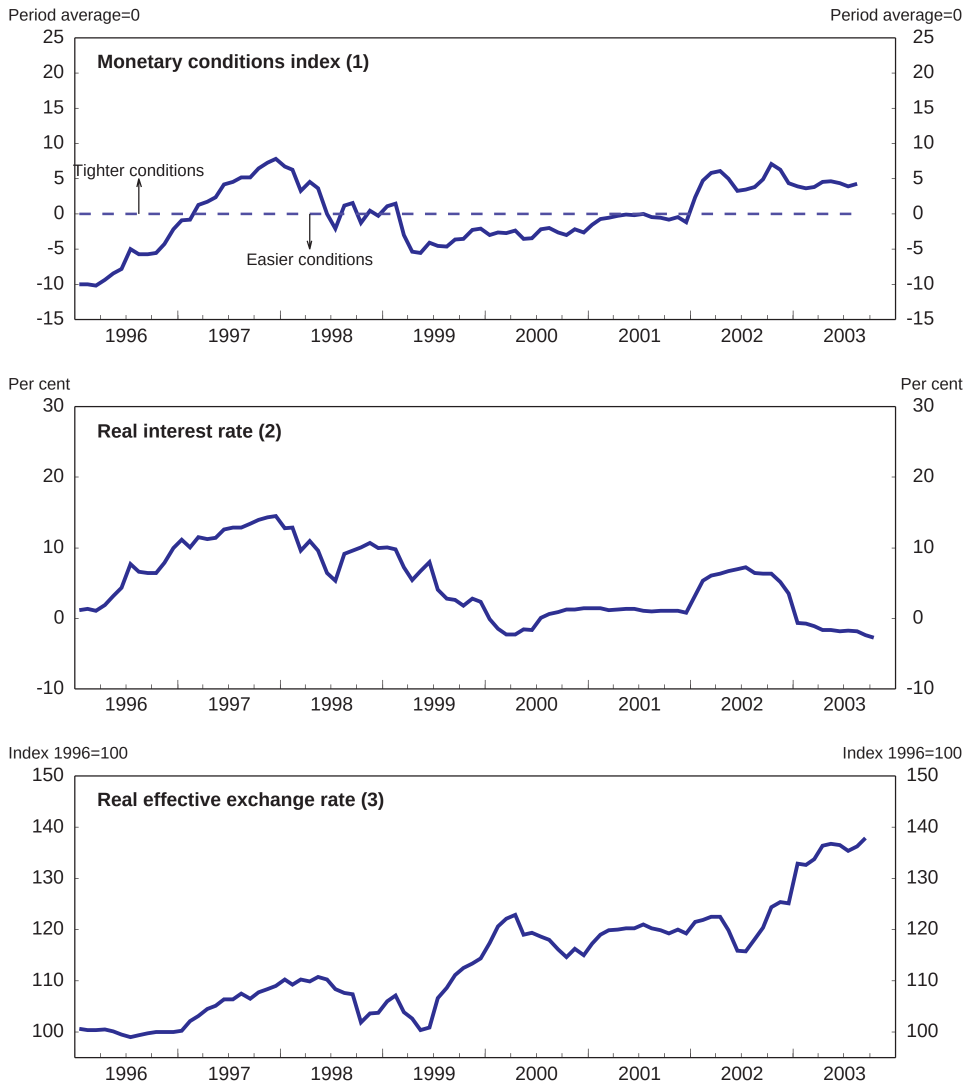
high nominal returns on investments and expectations of further currency appreciation have meant that Slovakia remains an attractive destination for foreign capital. In fact, the foreign exchange reserves of the country have almost steadily increased from a level of US$9.7 billion in September 2002 to US$13.3 billion in September 2003.

Medium-term monetary policy objectives seem achievable

The strengthening Koruna and relatively high policy interest rates have resulted in monetary conditions that have been tighter during 2002-03 than in the years before (Figure 11). While core inflation is low, this policy stance has to be seen against a background of strong economic activity, substantial fiscal deficits, and inflationary pressures from administered price and indirect tax increases. The medium-term objective of the NBS is to reduce inflation by 2006 to levels consistent with the Maastricht criteria. Achieving this goal seems feasible if second round effects of administrative price increases can be contained and public spending can be reined in successfully.

The NBS expects a continuing reduction in headline inflation over the coming years. The updated Monetary Programme for 2003 forecasts an inflation rate path for the years 2004 to 2006 of about 8.3 per cent, 3.6 per cent and

Figure 11. **Monetary conditions**



1. The monetary conditions index is defined as MCI = MCI[t – 1] * (1 + (r – r[t – 1]) + w *(e/e[t – 1] –1)), r = real short-term interest rate, e = real effective exchange rate, based on CPI, w = weight based on share of imports to GDP. The index is shown as a percentage deviation from the period average. A value higher than zero indicates tighter conditions than on average.
2. Three-month treasury bill, core inflation deflated.
3. Real effective exchange rate calculated with forty-two countries, based on CPI.

Source: OECD.

2.9 per cent. The further increase of administered prices towards cost-recovery levels (adding about 3.5 percentage points to underlying inflation), convergence of indirect taxes on tobacco and tobacco products with those prevailing in the EU (adding a further percentage point), and higher food prices due to the implementation of the Common Agricultural Policy (CAP) following Slovakia's accession to the EU on 1 May 2004 (adding about 0.7 to 0.8 percentage points) will be the main determinants of price developments in 2004. In 2005 and 2006, the extent of changes in regulated prices according to the framework laid down by the Network Industries Regulation Authority will be more modest, so that the impact of regulated price adjustments on inflation will diminish over time. Instead, headline inflation will be increasingly determined by supply and demand conditions in the economy, world commodity prices and the exchange rate, and will converge towards core inflation rates.

Core inflation is expected to jump to about 5.3 per cent in 2004, mainly as a result of the CAP-adoption-related surge in food prices. But in 2005 and 2006, the NBS forecasts that the core rate will recede to 2.4 per cent and then 2.1 per cent, hence bringing inflation almost down to the average level expected for the euro area at that time. Moreover, the Bank expects that favourable developments concerning inflation, the trade balance, and fiscal performance will make it possible to gradually align both official and interbank interest rates with those of the European Central Bank.

At the end of its medium-term outlook period, the NBS hopes to have achieved sufficient currency stability and inflation and interest rate convergence with the EU that, together with adequately low levels of fiscal deficits and public debt, Slovakia would be well placed for ERM II membership. Two to three years later, the country hopes to join the euro area. This frequently advertised, ambitious schedule has turned out to be helpful for increasing the public's awareness of the need to establish macroeconomic stability and reduce existing imbalances and, hence, to foster the political momentum for reform. Entry into the euro area along this schedule and based on the prior strict and sustainable fulfilment of the Maastricht convergence criteria would limit the transition period during which the NBS may have to deal with possibly fluctuating capital inflows (Box 3). Moreover, adoption of the euro could yield considerable economic benefits, although the loss of monetary independence would also expose the country to risks that would need to be carefully managed.

Consolidation of public finances

A bold fiscal consolidation is long overdue

After the split of the Czech and Slovak Federal Republic, Slovakia started in 1993 its own transition process with particularly heavy taxes and expenditures – it

Box 3. Benefits and costs of an early fulfilment of the Maastricht Criteria for Euro area entry

Upon accession to the European Union, Slovakia will participate in the Economic and Monetary Union (EMU) with the status of "Member State with a derogation" from adopting the euro. Admission to the euro area requires the fulfilment of the Maastricht convergence criteria on a strict and sustainable basis.

Nominal convergence rules for Euro Adoption

Criterion	Definition
Price stability	An average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability.
Fiscal deficit	The ratio of the planned or actual government deficit to gross domestic product does not exceed 3 per cent, unless either the ratio has declined substantially and continuously and reached a level that comes close to 3 per cent; or, alternatively, the excess over the 3 per cent value is only exceptional and temporary and the ratio remains close to 3 per cent.
Gross government debt	The ratio of government debt to gross domestic product does not exceed 60 per cent, unless the ratio is sufficiently diminishing and approaching the 60 per cent value at a satisfactory pace.
Exchange rate stability	Respect of the normal fluctuation margins provided for by the exchange rate mechanism on the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency 's central rate against the euro on its own initiative for the same period.
Long-term interest rates	Observed over a period of one year before the examination, an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability.

Source: OECD.

According to Slovakia's strategy for the adoption of the euro,[1] the Government and the National Bank of Slovakia (NBS) aim to "adopt the euro as soon as possible, *i.e.* at the moment when the Slovak economy can meet the Maastricht criteria in a sustainable manner". Available economic literature suggests the following benefits and costs of an early adoption of the euro.[2]

Box 3. Benefits and costs of an early fulfilment of the Maastricht Criteria for Euro area entry (*cont.*)

The principal advantage of joining the euro area early would consist of reaping the benefits of being a member of the currency union already from the early euro adoption date onwards. These benefits include lower transaction costs, elimination of exchange rate risks, reduced real interest rates, a stability-oriented macroeconomic framework, eliminated exchange rate intervention and sterilisation costs, and greater economic integration and investment. In addition, there are several process-related advantages of having a short transition period:

- *Anchor for policy reform*: An early target date for euro adoption would add credibility and urgency to Slovakia's fiscal consolidation and disinflation efforts. It would reinforce the stated aim of meeting the Maastricht criteria by 2006 and help to overcome political opposition to envisaged cuts in public spending and employment.
- *Sign of integration commitment*: Other accession countries have already announced early target dates for euro adoption. Doing likewise would send a signal to foreign trade and investment partners that Slovakia is committed to further structural policy reforms and does not intend to fall behind other accession countries in terms of integration with the EU.
- *Shortening the period of vulnerability*: An early accession to the euro area would naturally shorten the period during which the NBS would have to manage the exchange rate in the face of high and potentially volatile capital inflows.

On the other hand, there are costs and disadvantages from introducing the euro early. These involve the early loss of the monetary policy instrument for macroeconomic management and some associated risks:

- *Possibly insufficient real convergence*: In order to reduce the occurrence of asymmetric shocks, partner countries in a monetary union need to show a high degree of economic integration and have similar economic structures. Adoption of the euro would by itself tend to foster convergence in real incomes, including through lower capital costs, and trade and investment patterns with the euro area. But an early adoption of the euro would reduce the length of the period during which Slovakia could use its own monetary policy instruments to steer the economy towards real convergence in the case of the occurrence of shocks that affect Slovakia and the euro area differently. As convergence proceeds, the importance of having independent monetary policy instruments will decrease. The question then is to what extent Slovakia and the euro area have already sufficiently converged. Per capita incomes in Slovakia are just a fifth of euro area levels in current exchange rates and less than half in terms of purchasing power parities, implying that consumption patterns in Slovakia and the euro area remain different. This may require *ad hoc* monetary policy responses to asymmetric real income shocks arising from specific price pressures. Also, Slovakia's industrial activity, exports and FDI stock are concentrated in some sectors, notably transport equipment, making the country's trade and output sensitive

Box 3. **Benefits and costs of an early fulfilment of the Maastricht Criteria for Euro area entry** (*cont.*)

to international sectoral developments, possibly calling for monetary policy responses in case of sector-specific shocks. On the other hand, trade and investment integration is already high, with more than 60 per cent of Slovakia's exports going to the euro area and 80 per cent of all FDI originating in the latter.

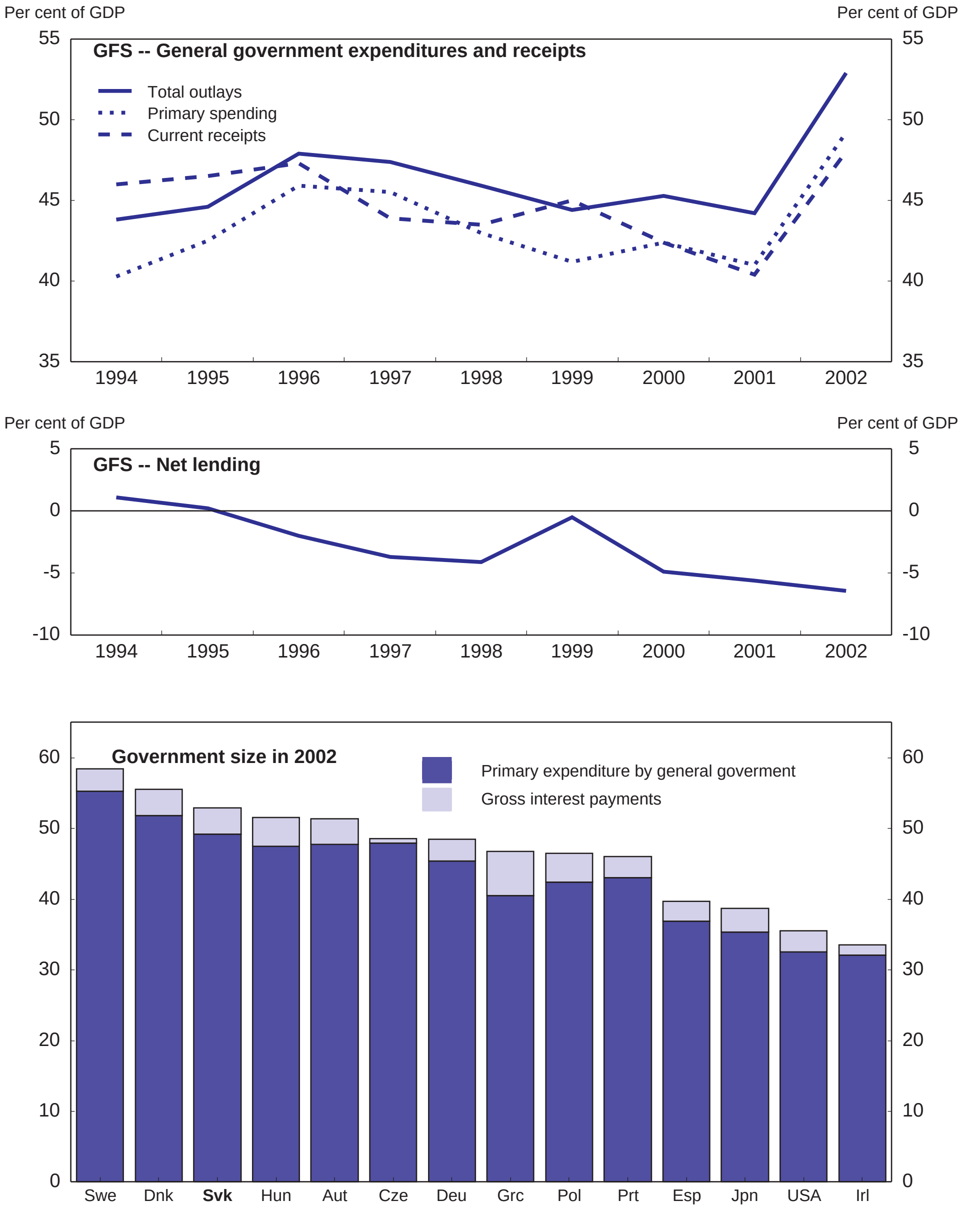
– *Possibly insufficient fiscal flexibility*: If the monetary policy instrument is no longer available, macroeconomic imbalances will have to be addressed through fiscal policy, while respecting the rules of the Stability and Growth Pact to which Slovakia is subject upon EU Accession as a "Member State with a derogation" and after entry into the euro area as a "participating Member State". In the medium-term, Slovakia will need to reach a budgetary position of close to balance or in surplus in order to achieve sufficient flexibility for automatic stabilisers to work without breaching the 3 per cent Maastricht deficit limit. Achieving the necessary fiscal consolidation, in addition and beyond the efforts already planned to meet the Maastricht deficit criterion, will be more demanding if euro adoption is targeted early.

Overall, the moment of entry and length of participation in ERM-II and the determination of a target date for euro adoption are important considerations and the Slovak authorities will need to carefully evaluate the benefits and costs of earlier or later target dates. Consultations between the Ministry of Finance and the National Bank of Slovakia are under way and their joint decision will be made public in June 2004.

1. National Bank of Slovakia & Ministry of Finance of the Slovak Republic. Strategy of the Slovak Republic for Adoption of the Euro. Bratislava, May 2003.
2. See, for example, Italianer (2003), Natalucci and Ravenna (2002) and Nuti (2002).

had the highest share of primary government expenditures in GDP among the CEC-5 countries in 1994 (Figure 12).[7] Moreover, pro-spending policies in the early years of transition raised the share of government revenues and spending further, to 43.5 per cent and 44.9 per cent of GDP respectively on a GFS-86 basis in 1996. After the formation of a pro-reform government following the general elections in 1998, the share of public revenues and expenditures was brought back to 35.7 and 41.3 per cent, respectively, in 2001.[8] However, during this period taxes were cut more rapidly than expenditures, and spending reduction often appeared to lack firm underpinnings. Expenditure cuts seemed to concentrate on the items of least resistance in the budget and were followed by appropriation catch-ups and spending over-runs, while tax and non-tax revenues tended to be systematically overestimated. As a result deficits grew and the public debt exploded to a

Figure 12. **General government fiscal balances**[1]



1. Data is not fully consolidated, possibly creating a particularly large distortion in 2002.
Source: OECD.

projected 38.3 per cent of GDP according to GFS-86 (cash) and 45 per cent of GDP according to ESA-95 (accruals) method in 2003 (see Table 20 below).[9]

The 2002 budget targeted a reduction in the general government deficit to not more than 3.5 per cent of GDP on a GFS basis. By April 2002 it became already apparent that this original target was not attainable due mainly to a much larger increase in public sector wages entailed by a new Civil Service Act. The deficit for 2002 was then estimated to reach 5.5 per cent of GDP. The government took some corrective measures after the elections on both the spending and revenue sides to contain the deficit, but it is difficult to evaluate the precise outcome of public finances in 2002. The difficulty of consolidating general government accounts properly in the course of newly started decentralisation makes the analysis of these accounts particularly hard (Table 9).

The measurement of the fiscal deficit in 2002 is in fact highly dependent on the particular method chosen. The cash-based GFS-86 accounting method excludes expenditures on newly granted state guarantees and the bank restructuring and debt-reducing outlays of the National Property Fund. When using the ESA-95 methodology to account for the excluded expenditures and the likely-to-be-called state

Table 9. **General government accounts**[1]

In per cent of GDP

	1996	1997	1998	1999	2000	2001	2002	Adjusted budget 2003
Direct taxes	10.1	8.6	8.8	8.3	7.4	6.7	7.1	7.1
Social security	15.8	15.0	14.4	13.8	14.3	14.4	14.7	14.3
Indirect taxes	14.0	13.6	12.5	12.5	13.3	11.6	12.1	13.0
Transfert rec. by gvt	6.1	5.6	6.7	6.3	6.0	6.1	13.3	7.2
Property income	1.3	1.1	1.1	4.2	1.4	1.6	0.9	0.7
Total income	47.3	43.9	43.5	45.0	42.4	40.4	48.0	42.3
Government wages	9.6	9.3	9.3	9.2	8.8	9.5	9.0	8.3
Government consumption	11.9	12.3	10.8	10.2	10.3	9.5	10.1	10.7
Social security benefits	9.5	9.3	9.5	9.5	9.4	9.0	9.1	8.9
Other transfers	7.3	6.5	7.2	7.1	7.1	7.8	16.0	10.9
Subsidies	3.3	2.8	2.5	2.2	3.8	2.0	1.6	1.9
Interest paid	2.1	1.9	2.8	3.2	2.9	3.2	3.7	3.1
Current outlays	43.7	42.2	42.0	41.3	42.2	41.1	49.5	43.7
Government investment	4.2	5.2	3.8	3.0	3.1	3.1	3.4	3.2
Total outlays	47.9	47.4	45.9	44.4	45.3	44.2	52.9	46.9
Saving	3.6	1.7	1.5	3.7	0.2	–0.7	–1.5	–1.4
Net capital outlays	5.6	5.4	5.6	4.2	5.0	4.9	4.9	4.2
Net lending	–2.0	–3.7	–4.1	–0.5	–4.9	–5.6	–6.4	–5.5
Total expenditure	49.3	47.6	47.7	45.5	47.2	46.0	54.4	47.9

1. Data is not fully consolidated, possibly creating a particularly large distortion in 2002.
Source: Ministry of Finance.

guarantees, the budget deficit in 2002, according to the latest government calculations, amounted to 7.2 per cent of GDP. A new law, passed in 2003, limits the use of state guarantees and hence should help to restrain hidden public deficits in the future. Concurrently, the authorities started to convert their fiscal accounts to meet the ESA-95 standards on a more systematic basis from 2002, which will contribute to increased transparency, but the shift of methodologies is also making the interpretation of the fiscal stance more complex. Fully consolidated general government accounts on either GFS- or ESA-95 methodology but covering the recent multi yearly period on a consistent basis are needed.

But consolidation efforts are under way

For 2003, authorities are targeting a fiscal deficit of 5 per cent of GDP on an ESA-95 basis. Concerning revenues, indirect taxation was reformed at the beginning of 2003. The standard VAT rate was reduced from 23 per cent to 20 per cent, while the lower rate was raised from 10 per cent to 14 per cent. Moreover, the government adopted a comprehensive tax reform package in June 2003 (Box 4). The set of changes in direct and indirect taxes were supposed to come into force from 1 January 2004, but lower than budgeted VAT and corporate income tax revenues in early 2003, which were only partly offset by higher proceeds from social security contributions and lower net interest payments on debt, induced the government to advance the implementation of parts of the tax reform package in order to meet its fiscal target for 2003. In particular, the planned increases in excise taxes on tobacco, alcohol and fuels were already undertaken in August 2003. On the spending side there seem to be slippages in health and education as the planned reductions in employment in these two areas do not seem to have materialised. The government has cut planned infrastructure investment to offset this. Overall, the deficit target for 2003 seems likely to be met.[10]

An ambitious medium-term plan has been launched

The authorities presented an ambitious consolidation plan covering the period to 2006 (the end of the ongoing legislature) in their latest Pre-accession Economic Programme submitted to the European Union in the summer of 2003. The plan aims at cutting the share of public expenditures from 49 per cent of GDP in 2002 on an ESA-95 basis to 41.2 per cent in 2006, and of public revenues from 41.8 to 38.3 per cent.[11] If successful, this would meet the EMU fiscal benchmark by 2006 by lowering the government deficit below the threshold of 3 per cent of GDP.

As the fiscal deficit starts from a very high figure of 7.2 per cent of GDP in 2002 and further cuts are projected in revenues, the size of the spending reduction is exceptionally large. Cuts are forecast in government non-wage consumption (a saving of 0.5 per cent of GDP over 4 years[12]), health expenditures (0.9 per cent

Box 4. The 2004 tax reform package

Slovakia initially established a traditional tax system. Personal income taxes (PIT) were subject to progressive rates and corporations were taxed at the standard rate of 40 per cent (small firms were taxed at 2 per cent of their turnover). PIT rates were set at 15-40 per cent and VAT rates at 6 per cent for most goods and services and 23 per cent for the others. Social security taxes added a 50 per cent wedge over net wages. PIT accounted for approximately 8.2 per cent of total tax revenues in 2002, corporate income tax (CIT) accounted for 10.2 per cent, VAT for 22.6 per cent and social security taxes for 43.5 per cent. Successive rate reductions were introduced in the course of the legislature following the 1998 elections. The CIT rate was cut to 29 per cent in 2000 and to 25 per cent in 2002 with generous tax holidays for new investment. The lowest PIT rate was cut to 12 per cent in 2000 and to 10 per cent in 2002 with a large increase in tax allowances as well as the minimum threshold. The top PIT rate was cut to 38 per cent in 2002. In compensation, the standard VAT rate (for most goods and services) was raised to 10 per cent in 2000 and 14 per cent in 2003.

A bolder tax reform was among the prime election promises of the new government which was formed in October 2002. The main objectives of the changes are to reduce the work disincentives of taxation, increasing the transparency of the tax system, and reduce distortions from tax exemptions and double taxation. The main part of the tax reform package, which will take effect in January 2004, consists of introducing a flat marginal rate of 19 per cent for personal and corporate income taxes, while increasing the deductible allowances for low income earners to 160 per cent of poverty-line incomes. Virtually all other exceptions, exemptions and special regimes are eliminated. Moreover, the standard and the lower VAT rates will be unified at 19 per cent for all products. In addition, the reform applies new guidelines for property taxes, replacing size-based with value-based assessments and removes inheritance taxes as well as taxes on dividends and real estate transfers. Incomes from different sources are treated more equally, which should lead to efficiency gains, and in connection with the elimination of tax exceptions, exemptions and special regimes to a considerable simplification of the tax code.

According to analysis by the Ministry of Finance, revenue losses from PIT and CIT rate unifications and tax reductions will be offset by increased proceeds from indirect taxation. However, in the absence of reliable data on the level and distribution of corporate and personal revenues, it is difficult to project corporate and personal tax revenues after the reform. Several institutions, including the IMF, Infostat, the Institute of Financial Policy, a commission of tax experts, and the Slovak Academy of Sciences have assessed the likely impacts of the new tax package and provided estimates that range from a revenue shortfall of SKK 2.5 billion to additional revenues of SKK 9.3 billion. While the projections of the Ministry of Finance are among the most prudent of the available impact-estimates, the possibility of a shortfall in tax revenues compared with budgeted figures for 2004 can not be entirely ruled out.

of GDP), welfare and labour market benefits (0.8 per cent of GDP), education spending (0.3 per cent), housing and industrial subsidies (0.3 per cent), and pensions (0.2 per cent). Lower interest payments on public debt, via debt reductions through privatisation proceeds and interest-rate drops, permit savings of 1.5 per cent of GDP. Cuts in government guarantees – which are included in government expenditures on a risk-adjusted basis in the ESA-95 methodology – are also expected to save 1 to 1½ per cent of GDP.

The authorities insist that these reductions are in terms of *shares* of GDP that is growing rapidly at a rate of more than 4 per cent, and that *levelsof real expenditures* are expected to remain stable in most spending areas. This does not make the targeted consolidation easier, however, since according to international experience rapid GDP growth puts pressure on government expenditures, in particular government wages and transfers. The pre-accession economic programme's fiscal projections are not legally binding, at either national or EU levels, but they represent a highly visible policy statement and set a credibility benchmark for economic policy. Departures from them would call for explanations to domestic and international constituencies, investors and observers.

The plan aims at simultaneously overhauling the tax system, redesigning the main budget institutions, and making a leap forward in the devolution of spending power to sub-central government.[13] For the most part it will come into force in 2004, alongside the phasing-in of new stages of pension and health reforms. In this respect, the 2004 budget is crucial to underpin this consolidation plan. It aims at reducing the deficit further to 3.9 per cent of GDP, largely through spending cuts. Even though the government has adopted conservative revenue estimates, revenue shortfalls cannot be excluded following the radical tax reform. On the spending side too, there are risks of slippage largely linked to the on-going process of decentralisation. This process could, in particular, make the achievement of the planned adjustment in public employment difficult and entail further increases in the arrears within sub-central government layers.

Looking beyond 2004, medium-term pressures are looming on the fiscal horizon. Additional social contribution cuts will be needed in order to strengthen labour supply and demand.[14] Transportation and education infrastructures will need upgrading, necessitating extensive public investment in certain areas in spite of the intended growth of commercial investments. Some of the required investment, notably in the areas of trans-European transportation networks and environmental protection, will be related to EU accession. If a fundamental spending overhaul does not take place, these pressures will make the attainment of the pre-accession programme difficult. Moreover, over a longer horizon population ageing would confront the country with a steadily growing pension deficit.

The current government objective of meeting the budget deficit criterion of 3 per cent of GDP in 2006 does not yet take the impact of the recent pension reforms into account. The establishment of a second pillar in the pension system is pursued by diverting contributions from the existing PAYG-system of about 1 per cent of GDP per year in the short term. This revenue loss in the first pillar is scheduled to be financed mainly from earmarked privatisation receipts obtained in 2002. Yet, the shortfall of PAYG incomes would add to the current deficit and could jeopardise achievement of the 3 per cent target. The pension reform in Slovakia raises economic accounting issues as regards the classification of the second pillar inside or outside general government. A classification of the second pillar outside general government would influence negatively the general government balance as the social contributions paid to the second pillar would not be registered as general government receipts. Should the Sovak authorities be obliged to classify the second pillar outside general government, the authorities may then decide to make additional consolidation efforts to meet the 3 per cent target as planned by 2006, or extend the timetable to allow for more time for fiscal consolidation. Latest government discussions on the matter focus on the objective of limiting the cash-costs of the second pillar reform in order to ease the trade-off.

III. Rationalising public spending

This chapter first reviews the recent trends in public spending and the budget procedures which underpinned their unsustainable pattern. It then analyses the extensive set of reforms now being introduced and discusses requirements for improving their chances of success within a short time span as presently planned, in the light of other OECD countries' experiences. It finally reviews the challenges in moving forward with reform and provides a detailed set of recommendations for specific actions to improve both the framework of fiscal policy and the operation of the public sector (Box 10).

An unsustainable spending path in the post-transition decade

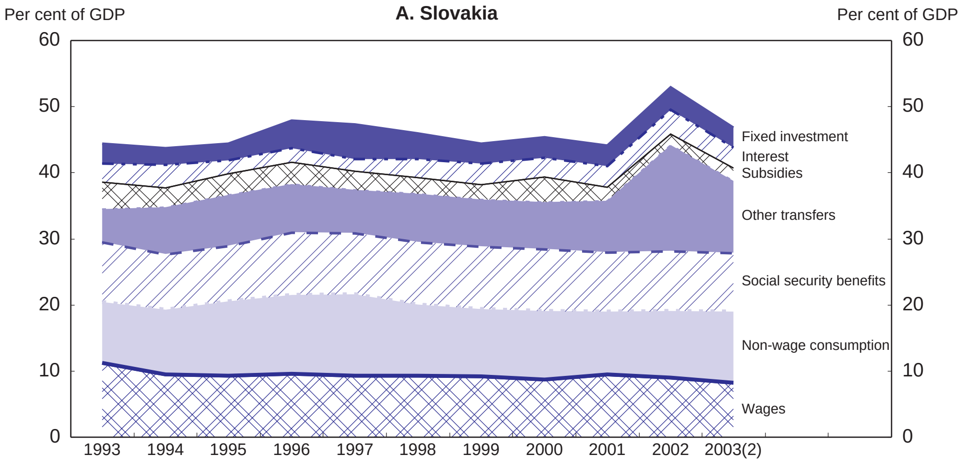
The spending growth was driven by social transfers and public employment

Public expenditure during the first decade of transition followed a pattern reminiscent of all OECD post-transition economies. It was characterised by the massive weight of social transfers and of the government wage bill. The public sector wage bill has remained significant in spite of subdued wages because of the very high level of government employment. Health care costs, recorded in the form of both social transfers and government wages, also remained large due to the generous terms of social insurance.[15] Sizeable subsidies were provided to enterprises to compensate for the losses arising from regulated prices that do not reflect costs (Figures 13 and 14). Total spending has attained a level well above the size of expenditure common in lower income OECD countries and this gap appears more pronounced because of the lower per capita income of Slovakia (Figure 15).

The composition of general government expenditure – including extra-budgetary funds which played an important role until 2001 and the rather less significant municipal spending – presents certain peculiarities when compared to other post-transition countries:

– The share of social transfers in GDP is slightly lower (13 per cent in 2001 against a Central and Eastern European Countries' average of more than 14 per cent[16]), though this is likely a temporary phenomenon due to favourable demographic factors which keep the pension claims relatively

Figure 13. Economic classification of public expenditure[1]



B. International comparison, 2002[3]

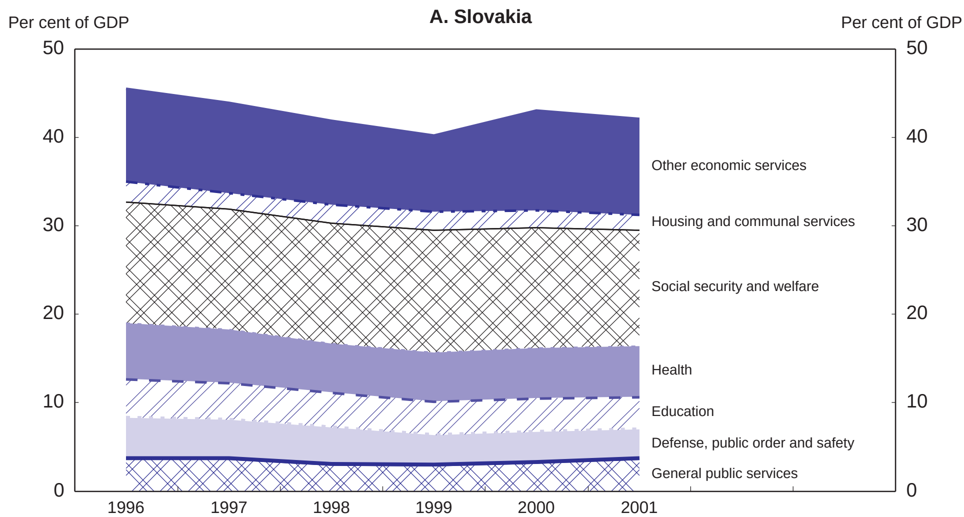
Per cent of GDP

	Income transfers	Subsidies	Interest payments	Government consumption Total	Government consumption Wages	Gross fixed investment	Other net transfers	Total outlays
Austria	18.8	2.8	3.6	19.0	9.8	1.3	6.5	51.9
Czech Republic	13.2	3.0	1.4	20.7	8.2	4.6	6.9	49.9
Denmark	17.5	2.2	3.7	26.3	17.6	1.8	4.2	55.5
France	18.1	1.3	3.1	23.8	13.7	3.0	4.1	53.4
Germany	19.4	1.5	3.1	19.2	7.9	1.6	3.8	48.5
Greece	16.4	0.2	5.5	15.5	12.1	3.8	4.9	46.3
Hungary	16.0	3.4	4.1	18.6	11.9	5.6	3.9	51.6
Ireland	8.3	0.8	1.4	15.1	8.3	4.4	3.5	33.5
Italy	17.1	1.0	5.8	18.8	10.7	1.8	3.1	47.7
Japan	10.6	0.7	3.2	17.9	6.9	4.7	1.4	38.7
Korea	4.2	0.4	0.6	10.4	7.6	6.0	3.9	26.0
Poland	17.6	0.9	4.2	14.9	10.7	3.3	0.6	41.6
Portugal	12.9	1.5	3.0	21.1	15.4	3.4	4.1	46.1
Spain	12.3	1.2	2.8	17.8	10.3	3.4	2.3	39.7
Slovakia[4]	**8.9**	**1.9**	**3.1**	**19.0**	**8.3**	**3.2**	**10.9**	**46.9**
Sweden	17.9	1.6	3.2	28.0	16.3	3.2	4.4	58.4
United Kingdom	13.6	0.4	2.0	20.0	7.4	1.3	3.5	40.8
United States	12.1	0.3	3.0	15.5	9.6	3.4	1.2	35.5
Euro area[5]	16.7	1.3	3.7	20.2	10.7	2.4	3.9	47.9
OECD[5]	12.5	0.8	3.0	17.3	9.3	3.2	3.1	39.0

1. Data is based on Government Financial Statistics (GFS) but it is not fully consolidated, possibly creating a particularly large distortion in 2002.
2. Estimate by the Ministry of Finance.
3. National accounts based except for Slovakia.
4. GFS-based 2003 estimates by the Ministry of Finance have been used for international comparisons, to diminish the impact of the distortion in data for 2002.
5. Weighted average.

Source: Ministry of Finance, OECD, IMF and World Bank.

Figure 14. **Functional classification of public expenditure**

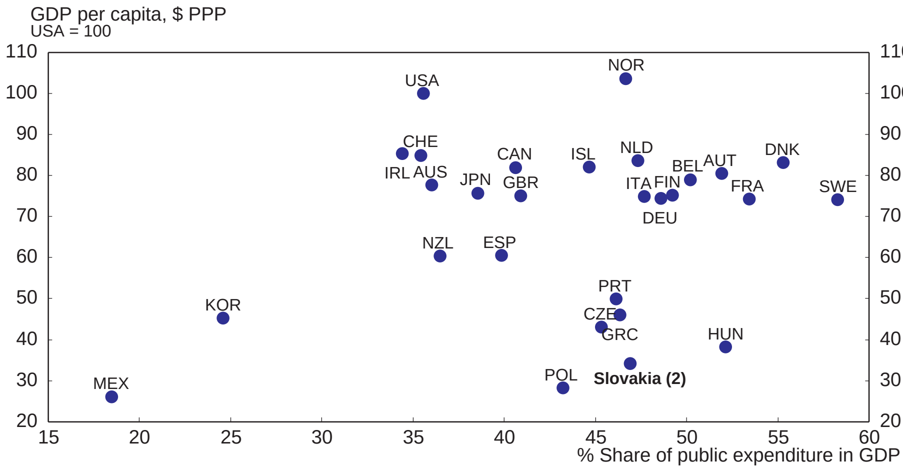


B. International comparison, 2001[1]
As per cent of GDP

	General public services	Education	Housing and community amenity	Health	Pensions and welfare	Economic services and subsidies	Defense, public order and safety	Total
Slovakia[2]	3.7	3.7	1.7	5.7	13.1	10.9	3.3	42.1
France	6.5	6.0	1.0	7.9	20.4	7.3	3.4	52.6
Germany	6.3	4.2	1.1	6.3	21.8	5.7	2.8	48.2
Austria	8.6	5.8	1.0	5.8	21.9	6.9	2.3	52.3
Denmark	4.5	8.3	0.9	5.4	24.2	5.3	2.6	51.3
Italy	9.5	5.1	0.9	6.3	17.7	5.8	3.1	48.3
Japan	2.3	4.3	0.8	6.5	11.2	6.5	2.4	34.0
Portugal	6.6	6.9	0.9	6.8	13.4	7.9	3.7	46.2
Spain[1]	5.6	4.4	1.0	5.6	13.5	6.9	3.3	40.2
Sweden	8.5	7.7	1.0	6.6	23.9	5.9	3.6	57.2
Belgium	9.9	6.2	0.4	6.6	17.4	6.1	2.9	49.4
Finland[1]	6.2	6.4	0.8	5.8	20.6	6.3	2.9	49.0
Greece[1]	10.0	4.2	0.2	3.9	19.6	1.1	4.4	43.3
Ireland	3.5	4.3	2.3	6.3	7.2	7.8	2.3	33.6
Netherlands	8.1	4.8	1.5	4.1	17.3	7.5	3.1	46.4

1. National accounts based except for Slovakia.
2. Latest data for Slovakia, based on Government Financial Statistics, available for 2001.
Source: Ministry of Finance, OECD, IMF and World Bank.

Figure 15. **Income per capita and public expenditure in OECD countries**[1]
2002



1. National accounts based except for Slovakia.
2. GFS-based 2003 estimates by the Ministry of Finance have been used for international comparisons, to diminish the impact of the distortion in data for 2002.

Source: OECD.

modest.[17] More structurally, the lower level of average benefits reflects the lower level of average wages (Table 10). As the share of labour income in GDP will increase with the catching up process the share of social transfers is bound to increase absent structural reforms. This pressure is particularly serious in pensions which represent the largest component of social transfers. Generous social assistance will also cost more in the future if the benefit parameters are not modified as presently

Table 10. **Wage/pension ratios**

	1995	1996	1997	1998	1999	2000	2001	2002
Minimum wage	2 450	2 700	2 700	3 000	3 600	4 000	4 400	4 920
Average monthly wage	7 195	8 154	9 226	10 003	10 728	11 430	12 365	13 511
Average old-age pension	3 320	3 727	4 124	4 490	4 878	5 382	5 782	6 104
Ratio average pension to average wage	46.1	45.7	44.7	44.9	45.5	47.1	46.8	45.2
Ratio average pension to minimum wage	135.5	138.0	152.7	149.7	135.5	134.6	131.4	124.1

Source: Social Insurance Agency.

planned by the government (For a detailed discussion of pension and welfare reforms see Chapter IV).

– Public consumption, at 19 per cent of GDP, is among the highest in the OECD area. The government wage bill at close to 9 per cent of GDP remains moderate in spite of prolific public employment because of low public wages. Should public wages for highly skilled employees converge more quickly to private wages, the government wage bill would grow even faster – unless the planned cuts in public employment are fully implemented. Excess employment and wage pressures are particularly serious problems in the education and health sectors (see Figure 16).

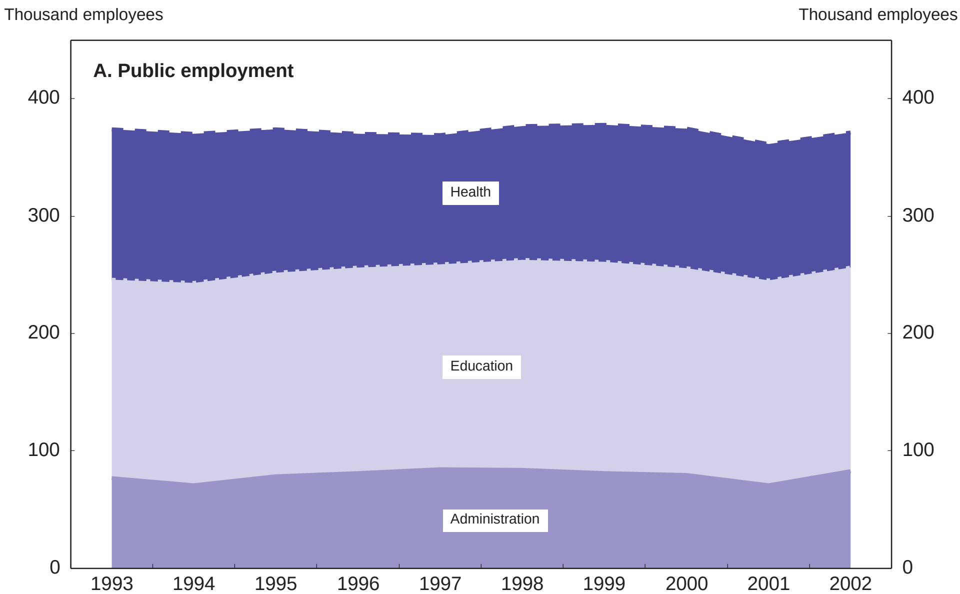
– Industrial subsidies have been higher than in other countries, reflecting large losses by the railways and regulated utilities, such as power generation and until recently gas distribution. Electricity, water, gas and fuel prices had been kept at particularly low levels through transition, and for a longer period than in the other post-transition economies, but recent adjustments permitted to reduce the associated losses and subsidies (Tables 11 and 12).

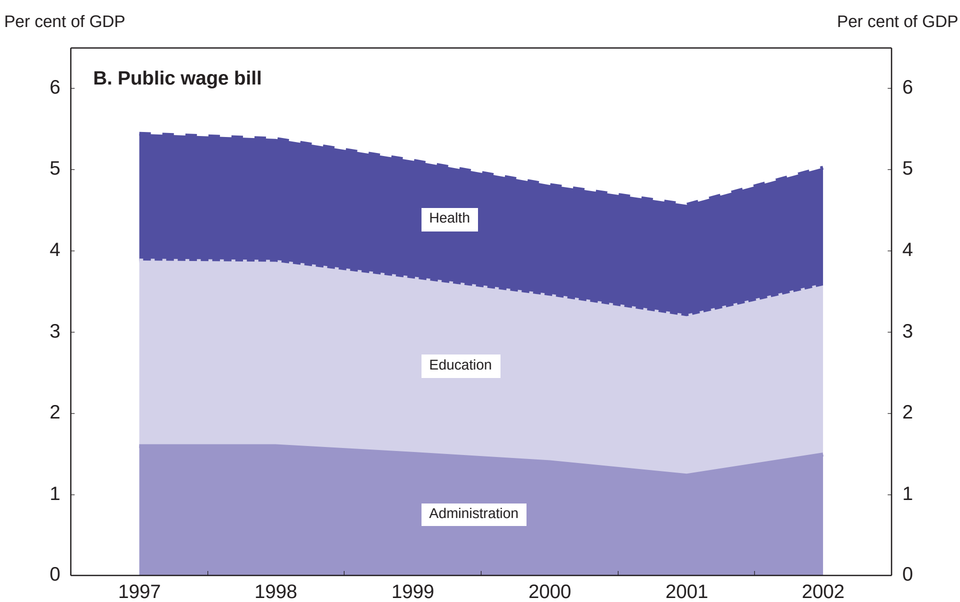
Costly public services

The low productivity of public services inflates fiscal spending. Until recently, the organisation of the supply of these services, both in state administration and in large-size collective services such as education, health care and rail transportation, had evolved little. Supply capacity and employment had remained largely static in these areas since the creation of the Republic in 1993. This is in contrast with profound changes in the society's needs and in the underlying technologies. As a consequence, large gaps have arisen between the *actual* and *potential* value for money in publicly provided services and have been filled by services produced by the private sector. Current trends in transportation and education offer telling illustrations.

Public transportation employs close to 100 000 workers (5 per cent of total employment) and is based on a dense railway network for interurban transportation, and on subsidised bus and tram services for urban transportation. While available capacity and employment have changed little in the last 10 years, service demand shifted rapidly to privately-supplied modes, notably road freight trucking and car passenger transportation (Table 13). Substitution is clearly taking place between railway and road-based transportation but pressures remain for duplicative investment in their respective infrastructures. Faced with growing fiscal constraints, the state was not able to cater to the large maintenance and development needs of both networks. Investments for both railways and roads had to be decreased, total public investment for infrastructures falling from 5.2 per cent

Figure 16. **Public employment and wages**





Source: Statistical Office of the Slovak Republic.

Table 11. **Energy prices**
2003, third quarter

	Electricity (US cent/kWh end-user price)	Natural gas (US$/$10^7$ Kcal end-user price)
Industry		
Slovak Republic	7.0	218.50
Czech Republic	5.3	206.80
Hungary	7.7	237.40
Poland	5.3	164.30
Households		
Slovak Republic	10.8	226.70
Czech Republic	8.3	325.60
Hungary	10.1	269.10
Poland	9.2	392.60

Source: International Energy Agency.

Table 12. **Price level of household utilities**
Ratio of household to industrial end-user prices

	1993	2000	2001	2002	2003 (Q3)
Electricity					
Slovak Republic	0.60	1.19	1.46	1.43	1.54
Czech Republic	0.56	1.27	1.40	1.55	1.57
Hungary	0.81	1.33	1.34	1.34	1.31
Poland	1.40	1.76	1.76	1.71	1.74
OECD Europe	1.80	2.06	1.95	–	–
Natural Gas					
Slovak Republic	0.62	1.07	1.08	0.95	1.04
Czech Republic	0.73	1.45	1.49	1.58	1.57
Hungary	0.91	1.33	1.16	1.14	1.13
Poland	1.33	1.86	1.75	1.95	2.39
OECD Europe	2.67	2.08	–	–	–

Source: International Energy Agency.

of GDP in 1997 to an expected 3.2 per cent in 2002. In terms of resource allocation in the transportation system, over-employment in railways in a sense crowds-out the development of the road infrastructure. The resulting poor quality and reliability of the transportation services, both for passengers and freight, are recognised today as a major hindrance to business investment, notably in the eastern regions where employment is lower.[18]

Serious problems of demand-supply mismatch also exist in education. Public education is a very large employer, its 173 000 workers representing 40 per cent of total general government employment and making up, in certain regions,

Table 13. **Shifts in transportation demand**
Transportation effected

	1993	2000	Percantage change
Goods transport (*billions of ton-km*)			
Rail	14.17	11.23	–26
Road	16.80	28.58	+70
Inland water	1.60	1.38	–15
Passenger transport (*billions of passenger-km*)			
Rail	4.57	2.87	–59
Automobile	14.36	24.41	+69
Bus	12.34	8.68	–42
Inland water	0.006	0.004	–50
Urban public transport (*thousand passengers/year*)	649	405	–60

Source: *Statistical Yearbooks of the Slovak Republic*, World Bank.

up to 15 per cent of the local employment. There is massive evidence of oversupply and qualitative shortcomings in these services. The most obvious are found in secondary education. Vocational education, which is a traditional area of strength in Slovakia, continues to absorb large and growing fiscal resources, while students increasingly seek general secondary education the supply of which is still limited (Table 14). As a result, there is growing demand for private and church schools which are more adapted to demand and also appear more cost-efficient than public institutions (Table 15). There are similar imbalances in university education, where available capacity in the most demanded disciplines falls short of demand, while established branches and chairs continue to be funded on a historical basis. There are also signs of crowding out of fiscal resources dedicated to tertiary

Table 14. **Shifts in primary and secondary education demand**
Number of students enrolled

	1990	1995	2000	Percentage change 1990-2000
Primary: total	721 687	661 082	650 966	–10
State	720 920	635 135	625 265	–13
Private	767	25 947	25 701	+3 250
Secondary general: total	55 644	76 380	80 615	+45
State	55 482	67 648	67 487	+22
Private	162	8 732	13 128	+800
Secondary vocational: total	224 584	248 892	195 016	–13
State	224 584	242 581	188 590	–16
Private	n.a	6 311	6 426	+735
Secondary: total	280 228	325 272	275 631	–1.6

Source: Institute of Information and Prognoses for Education, World Bank.

Table 15. **Costs of education institutions**

	1995	1996	1997	1998	1999
Expenditure per student in constant 1992 korunas (unit costs)					
Level of education					
Kindergartens	10 667	11 300	11 736	12 043	12 726
Primary schools	8 930	9 526	9 915	9 797	9 581
Secondary schools	9 793	11 045	12 927	12 792	12 536
Secondary vocational schools (MoE)	15 959	6 820	19 559	22 494	21 739
Church-affiliated schools	9 644	8 276	10 773	10 556	9 234
Private schools	5 264	3 569	4 305	6 156	5 150
Expenditure per student in percentage of unit costs in primary schools					
Level of education					
Kindergartens	119	119	118	123	133
Elementary schools	100	100	100	100	100
Secondary general schools	110	116	130	131	131
Secondary vocational schools	179	72	197	230	227
Special schools	212	238	258	258	248
Church schools	108	87	109	108	96

Source: Institute of Information and Prognoses in Education, World Bank.

education by primary and secondary tiers: teacher/student ratios soar beyond OECD averages in the latter while the share of GDP dedicated to tertiary education remains one of the lowest in the OECD. Demand is developing rapidly for private tertiary education, in spite of the high fees charged and the sometimes uncertain quality. It may be argued that since tertiary education returns are largely private, this area deserves more commercial provision and private funding of services. In all instances, present outcomes reveal serious value for money problems in publicly funded education.

Efficiency problems are also found in health services and the court system. A generous benefit package triggered exponential demand for health services. Payroll taxes for health remain the highest in the region at 14 per cent. Hospital admission rates rose by 18 per cent in the past decade, per capita outpatient visits by 20 per cent, and pharmaceutical consumption per capita grew at the highest pace in the OECD, even though the health status of the population did not improve commensurately.[19] Life expectancy remains low by the region's standards, and child and maternal mortality and morbidity rates from the main diseases remain comparatively high. Health expenditures have been contained at 5 per cent of GDP on a cash basis, but payment arrears have built up at more than 1 per cent of GDP per year and there are sizeable under-the-table payments for access to the most demanded services. Total health costs are likely to increase further as wages and prices in the health sector converge with average wages and prices in the economy (Table 16) and the population begins to age, even if the publicly funded proportion of spending might decline following reforms (see

Table 16. **Remaining price equilibration potential in the health sector**
Comparative price levels at current exchange rates, 1999, OECD = 100

	EU – 15	Hungary	Czech Republic	Slovakia
GDP Prices	99	42	39	33
Consumption goods prices	98	38	36	29
Investment goods prices	104	66	60	59
Health service prices	**84**	**19**	**19**	**13**

Source: OECD, *Purchasing Power Parities and Real Expenditures*, 2002.

below). The judiciary system, which consumes 0.2 per cent of GDP annually also presents major structural anomalies and comes only second to health services in terms of perceived corruption. A hypertrophied higher court system employs 90 Supreme Court judges and lacks specialised commercial courts. While most economic laws were successfully modernised (*i.e.* approximated to the *acquis communautaire*) they cannot be fully enforced, and certain segments of the population have no access to the court system at affordable cost[20] (Table 17).

Table 17. **Internationally comparative performance in the judicial system**
Perceived quality of public institutions[1]

	Rule of law		Control of corruption	
	1997/98	2000/01	1997/98	2000/01
Slovenia	0.83	0.89	1.02	1.09
Hungary	0.71	0.76	0.61	0.65
Estonia	0.61	0.78	0.59	0.73
Poland	0.54	0.55	0.49	0.43
Czech Republic	0.54	0.64	0.38	0.31
Lithuania	0.18	0.29	0.03	0.20
Slovak Republic	**0.13**	**0.36**	**0.03**	**0.23**
Latvia	0.15	0.36	–0.26	–0.03
Bulgaria	–0.15	0.01	–0.56	–0.16
Romania	–0.09	–0.02	–0.46	–0.51

1. The range is between –1.5 (worst) to +1.5 (best).
Source: William Davidson Institute, World Bank.

Recent efforts to reduce spending without structural reform

Past governments until the 2002 elections periodically reiterated their intention to restore fiscal sustainability, as regularly expressed in budgets at the beginning of fiscal exercises and in the medium-term pre-accession economic programs (PEPs) submitted to the EU. However, no fundamental reform in underlying spending areas was initiated. For instance, the ambitious 2001 PEP aimed to reduce the general government deficit from 3.3 per cent of GDP in 2000 to 2.7 per cent in 2004,[21] while also cutting tax revenues (Table 18). However, these intentions were overtaken by events and no savings were achieved in any of the key spending areas. A bold attempt to reduce welfare transfers to able-bodied beneficiaries – by halving them after two years of unemployment – did not really lead to savings as special public work jobs were ultimately offered to those most likely to lose from this measure. In the area of transport subsidies, an ambitious programme was introduced in 2000 to increase fares to cost-recovery levels but was subsequently watered down. Industrial subsidies did diminish in 2002 (current transfers were reduced from SKK 20 billion in 2001 to SKK 17 billion and capital transfers from SKK 23 to 8 billion, a saving amounting to 1.8 per cent of GDP in total) but there are concerns that transfers may have been actually shifted to other channels such as regional bodies subsidising their local utilities or consumers. Indeed during the same period subsidies to non-profit organisations and households increased by SKK 41 billion, more than 4 per cent of GDP.

These recent and unsuccessful consolidation efforts started always with attempts to implement across-the-board cuts in the main expenditure categories. Resources budgeted for social transfers, pensions, health and public employment were frequently nominally cut or increased less than nominal GDP, but these objectives were not backed by structural reforms in the respective areas. As equally observed in other OECD countries, such cuts proved short-lived. They gave rise to political pressures in the course of the budget exercises, or in the subsequent years, and intended cuts were typically offset or even reversed. Expenditures in the recent period 2000-2002 following the cuts effected in 1998-1999 confirm this inertia (Figure 17).

By contrast, infrastructure investment in transportation, utilities, buildings, schools and hospitals looked more flexible downward. Such expenditure turned residual when fiscal pressures became intense. In 2000 and 2001 government infrastructure investment, at 3 per cent of GDP reached one of the lowest levels among OECD countries. There is certainly room for refocusing and saving on

Table 18. **Expenditure projections and outcomes**

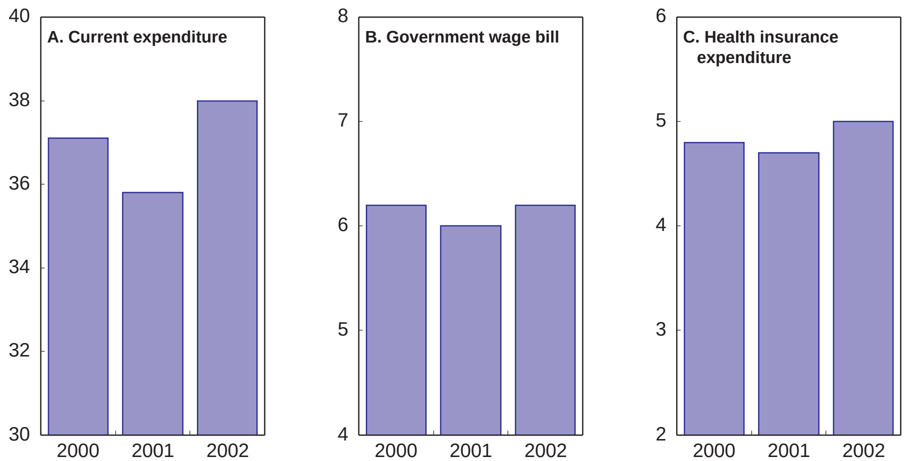
Consolidated general government expenditures as a percentage of GDP

	2000	2001	2002
As approved by the Parliament[1] (GFS)	37.5	39.1	38.6
Actual expenditures (GFS)	42.8	41.3	[52.9][2]
As projected in 2001 PEP (ESA-95)	–	46.6	47.0
Actual expenditures (ESA-95)	–	–	49.0

1. Estimation. No consolidated general government budget is voted by the Parliament. The voted state budget, including transfers to social security funds and local governments, provides the basis for the estimation of total expenditures.
2. Non-consolidated data.

Source: Slovak authorities.

Figure 17. **The inertia of the main expenditure categories**
Percentage of GDP



Source: OECD.

infrastructure investment but these cuts may have gone too far – without discriminating between infrastructure categories. There are signs of maintenance failures in important infrastructures.[22]

Budget procedures have been modernized but shortcomings remain…

Budget procedures have improved significantly since 1998. Before that Slovakia had no consolidated state budget and no central treasury and did not produce consolidated general government accounts. Large loopholes remained in the spending process via extra-budgetary funds and the reckless use of public guarantees.[23] In the past four years major breakthroughs were achieved in standard fiscal controls. Extra-budgetary funds have been integrated in the state budget, caps were put on public guarantees and granted guarantees were made transparent. A central treasury account was created. The state budget now consists of 49 chapters, each one specifying *total expenditures*, *current expenditures* (including *salaries and wages*) and *capital expenditures*. Appropriations for a chapter cannot be exceeded but each spending agency can make internal transfers within a chapter.[24] Budget preparation follows a fairly standard sequence, even if the social security and regional and local government budgets are not prepared fully in tandem with the state budget and there are shortcomings in the compilation of the consolidated general government accounts which become more serious with

Box 5. Preparation schedule of the 2004 Budget

January-April 2003	Ministry of Finance prepares the starting allocations and chapter limits for the 2004 state budget.
May 2003	Starting allocations, and chapter limits are approved by the government.
June 2003	Chapter administrators submit draft budgets to the Ministry of Finance in accordance with the approved limits. They formulate their proposals in economic categories (current expenditures, salaries, capital expenditures).
July 2003	Ministry of Finance consults with social security and health funds (via Ministry of Health in the latter case) and fixes deficit limits.
July 2003	Ministry of Finance briefs the Parliament about state budget preparation.
August 2003	Draft budget is submitted to economic ministers and to the government for discussion.
September 2003	The government approves the definitive draft of the state budget.
October 2003	The draft state budget, together with a general government deficit target, is submitted to the Parliament. Members of Parliament can suggest amendments – after consulting with the Ministry of Finance and approval by the "Committee for Finances, Currency and Budget". If amendments imply increases in expenditures, authors must specify financing sources by proposing cuts in other expenditures.
January 2004	Regions and municipalities inform the Ministry of Finance and the Parliament about their budgets.

decentralization (Box 5). Notwithstanding the important problem of consolidation, a full set of public accounts are made public with regular periodicity, according to international standards (Table 19).

The budget management process is broadly in line with average OECD practices but existing procedures are not strong enough to cope with the unusual pressures that the country faces. Strengthening budget procedures according to the best possible planning and control techniques available is necessary to meet the fiscal challenge. Three main shortcomings call for fundamental improvements in spending management:

– Established public expenditures are difficult to change and new initiatives tend to put upward pressures on aggregate spending. "Incrementalism"

Table 19. **Regular fiscal reporting**

Description		Frequency	Prepared by	Features
1.	Financial position of state accounts	Daily	NBS	Provides summary data on overall fiscal position. Gives cumulative data on: – total revenues; – total expenditures; – loan operations; – listings of K1 (payments due in next few days) and K2 (payments on the waiting list); – major taxes (VAT, excise, and income tax); and – state funds
2.	Report of balances on accounts of budgetary and subsidized organizations and subsidies to business entities from the state budget	Monthly	NBS	Provides fiscal data under following categories: – budget revenues; – extra budgetary revenues; – current and capital expenditures of budgetary organizations; – current and capital transfer to business; and – capital transfers entities.
3.	Budget execution reports from the line ministries and spending agencies	Quarterly	Line ministries/ spending agencies	Balance sheet and operating account. Revenue and expenditure report by major economic categories.
4.	Budget execution report from the municipalities	Quarterly	Municipalities	Balance sheet and operating account. Revenue and expenditure report by major economic categories.
5.	Consolidated budget report of the central government	Quarterly	MOF	Complied from the ministry reports (no.3). Contains balance sheet and revenue and expenditure accounts. Revenue and expenditure report by major economic categories.
6.	Health insurance accounts	Monthly	Health Insurance agencies	Provides summary data on: – revenues; – expenditures; – liabilities; – claims.

Table 19. **Regular fiscal reporting** (*cont.*)

Description	Frequency	Prepared by	Features
7. Social insurance accounts	Monthly	Social Insurance Agency	Provides summary data on: – revenues; – expenditures; – liabilities; – claims.
8. Unemployment insurance accounts	Monthly	National Labour Office	Provides summary data on: – revenues; – expenditures; – liabilities; – claims.
9. Summary report on budget execution	Monthly	MOF	Complied from the ministry reports (no.2). Contains balance sheet and actual revenues, expenditures, financing and deficit.
10. Revenues of public finances	Quarterly	MOF	Covers the general government. Contains data on revenues, expenditures, and deficit of the central government, state funds, and the local governments supported by charts and graphs. Compares current year's data with the data for the corresponding period last year. Gives data on central government foreign/domestic debt.
11. Final accounts of the Slovak Republic	Annually	MOF	Finalized and presented before the National Council within six months of the close of the financial year. Includes the following main statements: – report on the main features of accounts; – macroeconomic overview; – report on state funds; – consolidated statement of financial assets and liabilities; – brief report from the auditor general; – statement of total revenues and expenditures; – statement of revenues and expenditures of municipal bodies; and – consolidated local government budgets.

Source: Government of the Slovak Republic, IMF.

dominates the budget process. Spending ministries and agencies prepare their draft budgets year after year on the basis of previous appropriations and existing personnel and facilities. The Ministry of Finance, the government and Parliament have little leverage on these proposals and are not really equipped to assess the individual and comparative merits of the proposed programmes. In the preparation of the 2004 budget more substantive discussions than usual took place between the Ministry of Finance and line ministries, and some budget reallocations ensued, but this effort remained on a relatively thin informational ground. Both mandatory transfers and policy programmes appear fairly rigid and it is difficult to phase out the existing programmes and symmetrically introduce new initiatives. From the viewpoint of spending ministries, making proposals which imply resource shifts away from the status quo is risky because it can lead to the endorsement of saving proposals and the rejection of new spending ideas. As the respective merits of programmes are not documented and compared, policy changes are difficult to motivate. The audit system does not support budget flexibility either, as it lacks modern principles of functional auditing and self-auditing. Prevailing audits may be penalising innovative chapter managers: certain agencies were recently sanctioned for "using current funds for capital expenditure, or capital funds for wages" or for "not spending budgeted wage funds and keeping actual payrolls lower than budgeted".[25] There is a need to diffuse the "result-oriented" culture in all budgeting, financial control and audit functions of the general government on the basis of a full adaptation of the existing legal framework.

– Some spending loopholes remain and are conducive to drifts. The most obvious and costly fiscal loopholes were already eliminated, such as the reckless distribution of public guarantees, soft loans from government-controlled banks, and free-wheeling extra-budgetary funds. Other non-budgeted expenditure channels remain open, however, including sizeable payment arrears by public agencies,[26] wage and transfer increases granted during a budget year without voting new revenues,[27] the quasi-fiscal operational losses of the railways, and non-amortised physical depreciation in public infrastructures. Asset depletion escapes budget planning and control because spending is managed on a cash basis. Existing cash-based budgeting and monitoring should be complemented with accruals-based indicators, in line with international best practices.

– Implementation shortcomings amplify fiscal bills. There are inefficiencies and cost overruns in the procurement of goods and services which represent almost a quarter of total public spending. The Slovak Republic was the first post-transition country to adopt a Public Procurement Act in 1994 and adapted it to EU rules in 1999, but public procurement appears still vulnerable to corruption and abuse. Provisions concerning open tendering are rather satisfactory and permit competitive government purchases, but restricted tendering and negotiated tendering give excessive discretion to contracting authorities. On the other hand, the payment and settlement system is now being handed over by the Central Bank to the Treasury, raising certain concerns that the shift, besides the expected transition costs, may be facing design and human capital challenges which may weaken the integrity of budget execution. Territorial decentralisation compounds the challenges of preserving the integrity of the payment system (Box 6). No loopholes should

Box 6. **The difficult emergence of a treasury system**

Until 2002 the National Bank of Slovakia (NBS) served as the government's bank, ran the payment system and acted as agent for the management of government debt. A formal contract established the terms and fees for this service. But in practice it was provided free of charge, NBS finding that the service helped it in its conduct of monetary policy. Budgetary control was done through quarterly credit limits set for individual spending authorities by the Ministry of Finance (MOF). Separate accounts were kept for 6 000 subsidiary spending units, all integrated within a Treasury Single Account (TSA). NBS entered MOF limits for respective expenditure accounts in a computerised database and proceeded to payments according to spending authorities' instructions, after checking that cash balances are available in each account and instructions conform to rules. Periodical reports were sent to the Ministry of Finance on the situation of TSA.

MOF reportedly had three main difficulties with this arrangement: *i*) it found that budget execution information was late, incomplete and not sufficiently detailed for its purposes; *ii*) the spending commitments preceding payments could not be monitored, impeding cash management; and *iii*) cash balances were remunerated at NBS policy rates, below market rates.

The government adopted in July 2000 a "Strategy for Building a Treasury System" elaborated in co-operation with the EU. Specifications for a new hardware and software system was finalised at a total project cost of SKK 1 billion. About 15 000 revenue and expenditure sub-accounts were to be set up, and payments would be handled as before, within an integrated Treasury Single Account. However, limits for individual sub-accounts were not designed for direct entry in the computer system but were to be provided "manually" by the Budget section of MOF – a feature which was subsequently questioned. The purchase of this system became highly controversial, and the Public Procurement Office contested and cancelled the selection committee decision three times in a row. Completion of the project is expected in 2004.

be permitted to arise in the integrity of public payments and procurement as a result of decentralisation reforms. Procurement, financial control and audit capacities should be strengthened in all government layers.

Public debt has grown at a worrying pace

The recent growth of public debt has been phenomenal not least because of the large bank restructuring costs, with interest payments increasing by more than 1 per cent of GDP in the last six years (Table 20). Yet the level of official debt remains below European averages – and below the Maastricht benchmark. In addition, the magnitude of privatization revenues in 2002 helped reduce the public debt stock by SKK 59 billion (6 per cent of GDP) and another SKK 61 billion were dedicated to the reduction of hidden liabilities in public guarantees (Box 7). Significant non-tax revenue sources are expected to be exhausted however (after the full privatisation of the gas company SPP), and not more than 2 per cent of GDP is expected from privatization proceeds in 2003.[28] If the 2002 level of the deficit is not sustainably reduced, and the privatisation receipts are not systematically used to reduce public debt, Slovakia could hit the EMU ceiling on debt (60 per cent of GDP) before 2010. If a wider definition of public liabilities was used, including the hidden cost of environmental commitments,[29] the debt stock would presently attain 45 per cent of GDP on an ESA-95 basis. The proportion

Table 20. **Official debt and total public liabilities**

	1995	1997	1999	2000	2001	2002
In SKK million						
Consolidation Bank	–	–	99 625	140 516	32 345	30 179
State risk-adjusted guarantees	–	34 138	52 254	63 572	70 302	57 344
Guarantees and off-budget liabilities	–	34 138	151 879	204 088	102 647	87 523
Reported gross government debt	121 842	200 449	344 854	410 120	431 771	410 117
Total gross government liabilities[1]	121 842	234 587	496 733	614 208	534 418	497 640
In per cent of GDP						
Consolidation Bank	–	–	11.9	15.5	3.3	2.8
State risk-adjusted guarantees	–	4.8	6.3	7.0	7.1	5.3
Guarantees and off-budget liabilities	–	4.8	18.2	22.5	10.4	8.2
Reported gross government debt	21.4	28.3	41.3	45.1	43.6	38.2
Total gross government liabilities[1]	21.4	33.1	59.4	67.6	54.0	46.4
Memorandum item:						
Interest paid on public debt						
In SKK million	11 956	13 698	26 421	26 121	31 627	39 257
In per cent of GDP	2.1	1.9	3.2	2.9	3.2	3.7

1. Excluding the implicit pension debt.
Source: Ministry of Finance.

Box 7. How are privatisation revenues used?

Privatisation revenues jumped from SKK 2.3 billion in 1999 to SKK 40 billion in 2000, SKK 36 billion in 2001 and SKK 161 billion in 2002, attaining 16 per cent of GDP in this last year and 25 per cent cumulatively by the year end. The government reported that more than one third of the proceeds were used to reduce state debt, more than another third were blocked in a reserve fund for the second pillar of the planned pension reform, and the rest for reducing off-budget liabilities in the railways, health and education systems.

The government announced that it expects to realise SKK 18 billion in privatisation revenues in 2003 and a further SKK 16 billion in 2004. About 70 per cent of the 2003 revenues will be used to finance called guarantees inherited from the past.[1] The small amount of remaining revenues will be used to repay principal on state debt.

The largest asset which remains in state hands is the 51 per cent government share in the gas monopoly SPP. This company transports 70 per cent of the Russian natural gas heading to Western Europe and associated transit fees contribute a large entry to the Slovak balance of payments. A conglomerate consisting of Ruhrgas of Germany, Gaz de France and Gazprom of Russia, acquired a minority share with management rights in 2002. The government has not decided about selling its remaining stake because it expects growing future dividends. The electricity generator SE is also fully state owned and may have a large market value when divested from its liabilities; however, the government would have to clean SE's balance sheet and decommission its old nuclear plant first.

1. These are cash expenditures according to GFS standards but, in principle, should be allocated to the years of granting of guarantees in the accruals based ESA-95 standards. However, in the present application of ESA, the cash cost of past guarantees are booked in the year of disbursement.

would in fact be higher if the implicit pension debt – representing the discounted value of future PAYG deficits – was explicitly recognised, but no calculation of this liability is available.[30] These pressures underline the need for the authorities to pursue the comprehensive reform of public finances and deal with the underlying debt burden.

The new fiscal management system

Policymakers have long realised that prevailing budget procedures do not facilitate spending reforms. Not even the best budget procedures can substitute for political willpower in necessary reforms, but budget institutions may help or hinder such efforts by making the costs and benefits of spending programs more or less transparent, informing policymakers and the public about alternative options, and providing a more or less binding framework for the implementation of decisions.

Important initiatives were taken to modernise the fiscal system. These efforts have been intensified since the election of a new government in 2002. They cover a wide spectrum of fiscal management and contain many elements. Capacity-building for implementation appears, at times, to fall behind. Reforms could be too straining for available political and administrative resources. In spite of these shortcomings, the Slovak fiscal modernisation effort is one of the most far-reaching institutional transformation programmes launched in OECD countries in recent years.

A *medium-term fiscal framework*

A first step was made toward creating a medium-term budget framework in 2000, when the Financial Policy Institute (FPI) of the Ministry of Finance published three year projections of total budget revenues, expenditures and gross public debt. These projections were based on FPI's own macroeconomic forecasts. Even if spending projections were not negotiated with the Budget Section of the Ministry and later became controversial, the exercise was an important innovation and provided the background for the 2001 pre-accession economic programme (PEP) submitted to the EC. It, however, had no role in domestic policy making. Communicating with the EC remained the core motivation for the preparation of multi-year projections in both 2001 and 2002. These were equally non-binding and very optimistic in their revenue and spending forecasts (Table 18). They have nevertheless introduced ESA-95 based general government projections in Slovakia. In the following year, the 2002 PEP projections were produced for the entire general government sector, both on the GFS-cash and ESA 95-accruals bases.

The government then announced a major initiative in 2003, promising to submit a three-year budget framework to Parliament together with the 2005 budget act. The FPI was given the responsibility for projecting government revenues during the first three-year period, and its staff was strengthened accordingly.

The medium-term framework for 2005 will include the following elements: *i*) a baseline macroeconomic projection; *ii*) a revenue projection path on the basis of the tax package applicable from 2004; and *iii*) projections of *mandatory* spending which cannot be modified by policy decisions at the executive level but through a demanding parliamentarian process. On that basis, and taking into account the Maastricht objective for 2006, the room available for non-mandatory, discretionary spending will be calculated for the projection period. The medium-term framework is planned as an indicative document at this stage, and not as a binding budget voted by the Parliament.

This plan is an important step forward but suffers from certain weaknesses. First, general elections will be held in 2006 and the announcement of a medium-term fiscal framework is more credible when made effective at the beginning of a new legislature (it is nevertheless an achievement to introduce it, even in the course of the legislature). Second, revenue projections will be fragile as 2004 will be the first year of application of the new tax system and additional cuts in social-security taxes are difficult to plan in these circumstances. Third, ongoing territorial decentralisation makes spending projections difficult. Finally, the medium-term budgeting exercise has been designed principally in macroeconomic terms, and even if the government plans to provide functional spending projections for the main budget chapters, these may not be consistent with aggregate projections. A credible medium-term framework will need to be directly grounded in spending priorities (Box 8).

Functional budgeting

The Slovak Republic needs to reduce spending while reallocating resources from lower to higher priority uses. To make fiscal consolidation compatible with the necessary strengthening of public services and infrastructure, a results-oriented approach to budget making is necessary – even if this type of budgeting represents an experimental avenue even in the most advanced OECD countries. The authorities have taken important initiatives in this area in the past two years.

The government adopted in November 2001 a "Resolution on Programme Budgeting" and "Methodological Instructions of the Ministry of Finance for the Implementation of Programme Budgeting".[31] Four areas were selected for pilot applications of functional programmes in the 2002 budget.[32] Such chapters spelling out functional objectives were to be presented only *pro forma*, however, in parallel to the standard economic budgets which would be voted by the Parliament and remain binding. This feature made the experiment merely academic, because functional budgets require that programmes are given performance objectives and managers discretionary power in resource utilisation. Traditional economic budgets do not offer this freedom. Following the pilot projects launched in 2002, actual experiments will indeed begin in 2004 when the Parliament will vote and appropriate functional spending lines.

Early experience with pilot projects reveal communication problems between the Ministry of Finance as the main proponent of the methodology, and spending ministries. Further familiarisation and training is necessary in line agencies. International experience shows that functional budgeting succeeds when line agencies understand and support it fully, and do not see it as a burden and an additional reporting obligation. In each ministry an influential sponsor is required. The government recently created a working group including high-level line-ministry officials to analyse, assess and update functional budgeting.

It is useful to concentrate the pilot projects in spending areas where mismatches between costs and benefits are most blatant. Public transportation; primary, secondary and university education; health services; and the entire court system appear as natural candidates. The ongoing devolution of spending

Box 8. Medium-term planning of road investment

The planning of the road construction and its funding raise complex fiscal management challenges. Firstly, investment needs are particularly large, notably on a gross basis (including maintenance spending) while budget resources available are limited and proved unstable in the past. Second, lack of multi-year investment budgets make medium-term allocations and procurement vulnerable to policy changes. Third, road development come under a cascade of international and local planning layers that make consolidated planning difficult. Finally, if new room is opened for commercial motorways, then the respective contributions of public and private funding may be altered.

The present quality of the road network varies according to regions and types of roads. Western districts, including the Bratislava agglomeration, are relatively well connected to the European motorway network and FDI investors highly value this infrastructure. In contrast, eastern regions are poorly equipped with motorways and expressways, and this is a recognised hindrance to domestic and international investment. Maintenance backlogs have accumulated, notably in the so-called secondary (Class II) and smaller roads which are under territorial and municipal government responsibility and which represent 75 per cent of the road network. The World Bank estimated in 2002 that a pragmatic road maintenance and development schedule would call for annual investments of approximately $500 million.[1] Against this benchmark, the actual yearly investment of $215 million falls short by approximately 1 per cent of GDP. As more than 80 per cent of total road spending goes to new motorway construction, the gap is most serious for maintenance.

A National Road Fund created in 1990 to provide stable funding outside budget constraints faced chronic endowment and spending control problems and was dissolved in 2001.[2] No alternative financing scheme replaced it and the road budgets for 2002 and 2003 were cut to an unexpected degree. In the course of the latest budget exercise, in June 2003, the government nevertheless decided to allocate a further EUR 600 million (3 per cent of GDP) for highway projects in the next three years.[3] This funding programme will be backed by the EU and associated funds.[4]

Planning interdependencies between complementary roads is challenging. It is now becoming more complex under territorial decentralisation. Co-ordination between the Slovak national network and road networks in neighbouring countries (in the Czech Republic, Hungary and Poland) and at the trans-european level is facilitated by the role taken by the European institutions involved in co-financing. In contrast, subsidiarity under the national level creates co-ordination difficulties. Motorways and Class I roads will continue to be planned by the central government and operated on its behalf by the Slovak Road Authority (SRA),[5] and the layers below by regional governments. There is no clear scheme yet concerning the transfer of financing resources and technical expertise to regions and municipalities, including for the management of the highly important national road maintenance data base on pavements and bridges.

Box 8. Medium-term planning of road investment (*cont.*)

In these circumstances, proposals for some re-centralisation of road planning, financing and management have become more prominent. The World Bank launched the idea of a "reformulated" National Road Fund as a co-ordination mechanism. This Fund could finance the SRA and the regional road agencies and municipalities in accordance with "five-year road development plans". Yearly disbursements would be conditional upon the fulfillment of performance yardsticks in the plans.

The Slovak authorities seek to increase the role of commercial and private investment in road development but also consider that public-private partnerships are not yet fully effective in this area – in the light of the disappointing experiences in the Czech Republic and Hungary.[6] They state an intention to invite private investors to the launching of the D1highway project between Bratislava and Kosice in 2006. Cost-effective tolling on the basis of electronic vehicle identification and new metering technologies is expected to facilitate the commercial exploitation of roads.[7] However, the definition of the projects to be submitted to private bids remains controversial and highly dependent on the outcome of political negotiations.[8]

1. This estimate include $90 million for making up the maintenance backlog, $100 million for routine maintenance, $100 million for upgrading the network to EU axle weight standards (a five year investment programme) and $200 million for the minimal yearly development of the motorway network. A more extensive version of the motorway development programme would require $340 million per year.
2. The Road Fund suffered serious problems in practice: Firstly, multi-year investment planning proved impossible because of political interference. Secondly, resources could not be stabilised. The Fund was supposed to obtain 40 per cent of hydrocarbon tax revenues and 70 per cent of vehicle licenses fees but in practice in certain years it received not more than 6 per cent of anticipated receipts. Thirdly, borrowing went out of control, at rates much higher than interest on public debt. Total Fund liabilities had already reached 4 per cent of GDP in 2000. Finally, a technocratic and apolitical management could not be established and suspicions of illicit transactions proliferated in road construction contracts.
3. Including the D1 motorway connecting Bratislava and Kosice in the east, another dual carriageway connecting Bratislava and Kosice, and the East Slovakia highway in the north of the country.
4. A € 350 million loan (more than 1 per cent of GDP) from the European Investment Bank (EIB) was approved by the cabinet at the same time as the new highway projects. Additional road financing is expected from 2004, of an amount of SKK 5-6 billion (0.5 per cent of GDP) from the EU Cohesion Fund and of SKK 3 billion (0.3 per cent of GDP) from the EU Structural Fund. Slovakia also plans to apply for funding from the European Union's ISPA program to get additional € 160 mn (0.4 per cent of GDP).
5. In 2002, SRA signed an innovative road administration contract with the Ministry of Transportation, as a quasi-commerical entity, under an arms' length relationship.
6. See OECD *Economic Survey of Hungary*, June 2002 and OECD *Economic Survey of the Czech Republic*, April 2003.

Box 8. **Medium-term planning of road investment** (*cont.*)

7. Slovakia participates in major regional and European projects for electronic tolling, notably to a project for electronic vehicle screening among Czech Republic, Hungary and Slovakia, and to a plan to introduce electronic tolling for freight vehicles by 2007 which is endorsed by the European Union. A study identified a potential to generate yearly $23 million in the Slovak road market by 2005, assuming tolls amounting to 4 US cents per car km, in line with international standards.
8. A disagreement emerged recently within the government coalition concerning the precise trajectory of the principal motorway of the country between Bratislava and Kosice (project D1). The government delayed its final decision on this project after the ethnic Hungarian Coalition Party (SMK), which represents the Hungarian population concentrated in southern districts and is a junior coalition partner, requested priority implementation of the southern link. The pro-business coalition member ANO then proposed to build that corridor on a commercial basis, financed by private investors. According to ANO's officials, the southern route – running from Bratislava through Nitra (this section of the motorway is already completed) and Zvolen to Kosice – could be built in five years for SKK 50-55 billion (5 per cent of GDP) and would permit investors to recoup the investment through tolls. Meanwhile, the construction of the Bratislava-Kosice motorway proceeds on a more northern route, passing through Trencin and Banska Bystrica. A related issue is whether it would not be more efficient to build a motorway link from Kosice to the Hungarian border that could make the Budapest-Vienna motorway accessible to a larger part of Slovak population. Obviously, the fragmentation of small size central European countries and strong ethnical orientations make the rational planning of the road infrastructure more politically difficult.

authority to sub-central governments in education, health, transportation and welfare subsidies further compounds the task.

On the other hand, administrative decentralisation provides a natural experiment for functional budgeting. Sub-central governments will spontaneously explore alternative modes and organisations for the provision of similar services and social benefits. In principle they should discover freely, by taking different options, the costs and benefits of alternative avenues such as service delivery by public agencies, public-private partnerships, not-for-profit activities, commercial concessions and plainly competitive commercial providers. It must be stressed nevertheless that the proper implementation of functional budgeting at sub-central levels calls for clear performance targets and additional administrative and governance capacity, that may be in short supply, and which should be further developed. Central government should define national service objectives precisely and monitor their achievement, without drifting toward micromanagement.

Comprehensive budgets for accurate expenditure accounting

In January 2002, all extra-budgetary funds (XBFs), except the Agricultural Market Regulation Fund (transformed into an Agency), the Nuclear Fund (which accumulates revenues for the decommissioning of nuclear power plants), and the Housing Development Fund (which was to be liquidated in January 2003 but ran out of funds for mortgages and stopped accepting new applications) were abolished and their finances integrated in the budget. Earlier, the experience with the Road Fund was disastrous from a fiscal management viewpoint, as this Fund, because of the pressing road-building needs and a hectic decision-making setting (see above Box 8), had overrun its planed expenditures by a wide margin via direct borrowing.

After the integration of the XBFs in the budget, the key shortcoming in the integrity of budget accounts concerns the deficits of quasi-fiscal bodies which build up arrears and borrow under explicit and implicit government guarantees. Railways, the state-owned power generator, hospitals and health insurance funds, and, in the future, regional governments and municipalities – in spite of formal rules which limit their borrowing – are likely to remain risk areas.

Until last year, public utilities' losses have been justified by distributional objectives, in favour of low-income users and public-service obligations (PSOs). In practice, these losses were also due to massive excess employment and unprofitable investments. This financial burden was rarely fiscalised and took grey forms such as cross-subsidies within these large-size utilities, direct borrowing from financial markets, and payment arrears to suppliers.

The government is now determined to make these fiscal costs explicit and to show them in the budget, even if this comes at a cost. It launched a price-adjustment scheme in 2001 to bring the distorted energy tariffs to more neutral levels, in line with EU directives.[33] The implementation was delayed until 2003, after the election year.

Railways generate massive expenditures and deficits. The monopoly ZSR (divided into a service and a track entity in 2002) is formally in the corporate sector and its operations are fiscalised only occasionally by the take-over of its debts by the government. Unlike in the energy sector, fiscal regularisation cannot be effected by raising railway tariffs to cost-recovery levels, because of massive inefficiencies which would penalise the users. The government therefore decided to directly subsidise the enterprise from the state budget. For the first time in 2003 direct subsidies were provided to fully cover the PSO costs of the enterprise.[34]

Major progress has been made in improving the transparency of state guarantees, a big fiscal loophole until the late 1990s. The 2002 state budget set limits on new guarantees. All new guarantees to private financial and non-financial parties were to be monitored and recorded, and the expected schedule of future payments for existing loan guarantees were to be disclosed in the budget. The government decided not to grant any new guarantees except for rolling-over the guaranteed debts and securing finance for EU co-funded projects. However, large guarantees likely to be called had to be granted to railways and other government borrowers in 2002. New ESA-95 based government accounts and projections will include this information on a risk-adjusted basis.[35] More generally, complementing cash-based budgeting with accruals-based monitoring is being put into place, but only at a slow pace because of technical difficulties common in many OECD countries.[36] These difficulties are compounded due to the challenges created by the decentralisation reform for the accurate consolidation of intergovernmental transfers. These are large enough to create distortions even in the production of cash-based general government accounts (see Table 9 and Figure 13 above).

Devolving of spending power to sub-central governments

Slovakia is making an exceptional leap forward in regionalisation. From being the least decentralised transition country it is becoming one of the most decentralised ones within a very short time span (Box 9). The decentralisation reform not only responds to the political objective of developing participatory democracy but is also meant to enhance the efficiency of government by making it directly accountable to regional constituencies. Under present plans the share of public spending devolved to regional and municipal governments will attain 20 per cent in 2005. Sub-central governments will be funded by central government grants,[37] which will first remain itemized and then become progressively fungible. Sub-central governments have their own "federalist" interpretation of this plan as they envision to be entirely funded by untied grants by 2005.

Several important questions concerning the fiscal implications of decentralisation remain open at this stage:

– Will it be possible to plan, budget and implement the general government finances on a consolidated basis after decentralisation, on a short (budget year) and medium-term (multi-year fiscal framework) basis? Sub-central budgets will not be voted by the national Parliament – even if there is a need for co-ordination in areas where there are national externalities of local revenue and expenditure decisions. The current balances of sub-central budgets can be preserved – in principle – if budget rules are properly enforced, but revenue and expenditure *levels* cannot be controlled as sub-central governments have their own revenue sources (these are mainly fee-earning revenues at this stage, rather than own taxing powers which will increase in the future). Capital expenditures will be even less controllable as long as VUCs and municipalities have not reached borrowing caps. In sum, the planning and implementation of general government finances will remain difficult even if safeguards are available against excessive overspending. It is highly important to rapidly achieve the full transparency of sub-central government accounts and rigorously enforce the newly-prescribed sub-central budget rules.

– How will functional budgeting be applied in programme areas devolved to sub-central governments? Are there risks of excessive cuts if a functional

Box 9. The decentralisation reform

The Parliament adopted in the autumn of 2001 a set of basic laws creating Higher Territorial Units (VUCs or regions), amending the Act on Municipalities, and transferring 4.5 per cent of GDP of further spending responsibilities to the sub-central layers. Municipalities, which were previously in charge of waste disposal, drinking water, public lighting, and maintenance of local roads (where they spent 2.9 per cent of GDP in 2000) get the responsibility for social assistance, some registration bureaus, some roads and communication systems, territorial planning and building permits, environmental protection, primary schools, sports and parts of health care. VUCs become responsible for regional development, territorial planning, secondary schools, social assistance, health care, cultural events and protection of monuments, maintenance of regional road networks, communications, civil protection, and some co-operation functions with EU institutions.* Total sub-central (municipal and regional) spending with old and new responsibilities is expected to represent 15 per cent of total general government spending in 2003 and 20 per cent in 2005. The government approved in May 2003 the "Project of Further Decentralisation of Public Government for the years 2003-2006" to confirm that decentralisation should be completed by 2004 and that an "Act on Budgetary Rules of Territorial Self-Governments" should detail applicable budgeting and auditing provisions by 2005.

Under decentralisation the VUCs' and municipalities' budgets will be prepared annually. The approval and management of these budgets will remain the *exclusive competenceof elected representation* of VUCs and municipalities. Municipalities will not submit their budget proposals to any state authority. VUCs will submit their draft budgets for the upcoming budget year to Parliament and to the Ministry of Finance (MOF) *for information*. Both VUCs and municipalities are obliged to submit their quarterly income statements to the MOF.

There will be detailed fiscal rules for sub-central governments. The current budget must be balanced and borrowing will be permitted only for capital spending. Loans above SKK 75 million (about € 1.8 million) will require the MOF approval. A*fter January* 2005 total debt cannot exceed 60 per cent of current revenues of the previous year, and debt service (repayment of interest and principal) cannot exceed 25 per cent of current revenues. Certain municipalities such as Kosice (second largest Slovak city) are over-indebted, but the total official debt of municipalities was only SKK 14.7 billion in 2003 out of a total gross general government debt of more than SKK 500 billion.

Independent auditors will review the final accounts as well as the compliance of sub-central governments with existing laws, budget rules and debt limits. They will be responsible for warning the MOF of any breaches. A procedure of receivership will be put in place for municipalities that are not current on their accounts payable within 60 days. One remaining problem is that some regional governments have not appointed independent auditors, taking advantage of a legislative loophole – the existing legal norms pertaining to VUCs fail to specify how to enforce compliance.

* VUCs can negotiate financing with EU and EIB funds.

area does not enjoy adequate priority at the regional and local level? What kind of minimum service standards should be set by the central government in critical areas such as education, healthcare and labour market policies while avoiding micromanagement? Functional budgets at sub-central level may in principle facilitate spending rationalisation but transfers from the central government are effected today according to economic categories. It is not clear if it is proper to make central government funds fully fungible across economic categories at the discretion of sub-central governments, within a programme area. This may lead, for instance, to improper maintenance of capital assets, if there is a political bias in favour of civil service employment and wages. On the other hand, regional governments are better positioned to identify the most efficient ways of attaining performance objectives in local circumstances. In the area of public transportation for instance, they can discover the most effective network mix if they are allowed to shift resources between rail and bus budgets. They would also be motivated to introduce competition and challenger companies in each mode if they are free from supplier interests. Full transparency of sub-central government performances in service delivery would facilitate the responsible application and diffusion of results-oriented budgeting. The central government should make a special effort to promote this comparative transparency.

– Will sub-central governments be the *purchasers* or the *suppliers* of public services? The present central government strategy is to transfer both funding and supply responsibilities in a bundled way. Sub-central governments therefore become concurrently service agencies, owners of companies and, by the same token, political hostage to supplier interests. This is a hindrance to spending rationalisation when public services represent up to 30 per cent of regional and local employment and votes.[38] The experience of Slovakia and of other OECD countries reveals serious risks of supplier entrenchment under spending devolution, which might be magnified by over-reliance on central government grants.[39] Off-budget deficits and payment arrears in supplier organisations may also be a problem to be feared.[40] To enforce the "money follows users" principle freely and rigorously, it is necessary to liberate sub-central governments from supplier interests.

– How can complementarity between European, national, regional and local service networks be optimised under devolution? How to enhance the planning and funding of infrastructures in transportation, education, health and other services when there are externalities? The problem is compounded when there are network interdependencies in infrastructures, and hence risks of redundancies and mismatches across fragmented investments. How to avoid free-riding downward and upward devolution cascades? This standard externality problem in public finance is faced in a particularly acute form in Slovakia because of the speed of decentralisation and the severity of the budget constraints. The authorities will need to devise co-operation and co-ordination channels in transportation, education and health areas. International co-operation is also necessary across the frontiers of this small economy.[41]

Reform of the public employment regime to facilitate adjustments

A new public employment regime is being put in place following two acts adopted in 2001. The new *State Service Act* concerns more than 36 000 employees in central government except those in the special functions of police, army, customs, fire brigades etc. It sets minimum qualifications for state service detailed in a "Catalogue of Activities in the Public Service". Employees not meeting these criteria were to be given the choice between quitting with a 5 month wage compensation, or accepting a precarious job contract. Those having the required qualifications were to be given the so-called "preparatory" status and would take examinations within 6-24 months to become "state servants". However, practically none of these provisions could be implemented by October 2003.

The *Civil Service Act* concerned more than 400 000 employees in regions, municipalities, budgetary and contributory organisations (schools, hospitals, regional and district state administrations, social insurance funds, theatres, etc.). There are qualification criteria also listed in a "Catalogue". Employees who fulfill the criteria and submit an application will become public employees. Those failing the criteria were to lose their positions starting from May 2002 with, in principle, a severance pay amounting to two months of wages. The layoffs planned for May 2002 concerned employees of regional and districts state administration centres (12 per cent of the former and 5 per cent of the latter, together 770 positions, were to be cut). The initial plan failed as a result of successful pressures from line ministries, but the quantitative targets were subsequently attained by cutting the unfilled job positions. Conflicts between the Ministry of the Interior that was to organise the layoffs and line ministries were supposed to be resolved by a new *Civil Service Office*, whichcould not fulfill this mission.[42] On the contrary, there seem to be new risks that decentralisation increases the number of employees in general government, as posts newly created at subnational level are not fully offset by layoffs in district administration centres.[43]

These two Acts nevertheless establish a formally flexible regime for public employment, which remains subject to collective negotiations with public sector unions. The wage-setting framework provided by the new regime is adaptable. National salary scales prescribed by the legislation are anchored to "average private and minimum wage developments" but "within the possibilities of the state budget". Together with performance-based remuneration options and the latitude offered by functional budgeting, an environment now emerges that is conducive to quantitative and qualitative changes in public employment.

Four problems nevertheless persist:

– The new Acts conserve too many seniority-based pay steps. This impedes the recruitment of qualified professionals by crowding-out the budget available for new hiring. Highest seniority-based pay positions represent 20 per cent of the Public Service and a higher proportion of the Civil Service. Only 200-300 "elite positions" are available for the entire government sector for higher level recruitment independent of seniority. The allocation of these positions to line ministries is not based on comparative assessment of needs but on political bargaining between Ministries. More transparent and better co-ordinated allocation of new job positions would be desirable.

– There are conflicting signals emanating from the government on the stability of the new employment regime. For instance, the above mentioned individual evaluations planned for 2003 were not realised. The applicability of the Civil Service Act to sub-central employees is not guaranteed either, even if most local authorities favour it as a framework facilitating employment and wage negotiations. Certain government ministers mentioned recently "confusions and illogical provisions" entailed by the Acts mentioned above. The new regime of public employment should be fully clarified and the provisions of the new State and Civil Service Laws should be fully enforced.

– Public sector employees express concern that "performance-based pay" may lead in practice to the collapse of wages to their flat, "pre-performance premium" levels. Health employees' and teachers' unions have been particularly adamant about this prospect.[44] Indeed, downward leveling-off of wages is a risk in the absence of adjustment in employment levels. The trade-off between quantity and quality is dreadfully illustrated by the excessively low ratio of teachers' salaries to average wages, where Slovakia lags the entire OECD area.[45] The government should give signals that the vicious cycle of low wages, low motivation and low performance in public services will be overcome by employment cuts and better remuneration for well-performing employees.

– No large scale campaign is on the cards for the re-training of public servants. Training as "investment" faces here the same budget constraint as the other public investments. The consequences of this shortcoming of the public employment reform may be serious in areas where professionals are difficult to find in the labour market, such as teachers trained in new pedagogical tools and social workers able to work in demanding socio-cultural settings. The need for training is particularly acute in the implementation of new budgeting and financial control techniques.[46] Providing effective re-training for committed civil servants with insufficient skills should be a priority and be protected from budget cuts.

Reform of the social security system

As discussed in detail in Chapter IV, the pay-as-you-go (PAYG) pension system faces serious fiscal pressures. In May 2002 and September 2003 the government adopted a set of parametric changes which, backed by favourable demographic balances, should help enhance medium-term sustainability – even if longer term balances remain still unstable. The most important changes concerned the gradual lifting of the retirement age for women to 60 years as prescribed in May 2002, and the further increase of the retirement age for both sexes to 62 decided in September 2003. Benefits will be indexed to a mix of inflation and wage indicators. Authorities project that these changes will redress the PAYG balances, from a deficit of –4 per cent of GDP projected earlier for 2030.[47] There is further room for a gradual increase of the common retirement age to 65.

Foundation of a second privately funded pillar completing the PAYG system has been voted by the parliament and will be introduced in 2005. The present 28 per cent contribution rate would be partly (9 per cent) diverted to this second pillar. This would result in revenue shortfalls for the first pillar amounting to approximately 1 per cent of GDP per year, which will need to be funded from the budget.[48]

The health care system also faces mounting fiscal pressure, which shows up in arrears cumulating through funding layers. The current government has adopted measures to settle the debt as well as a new reform strategy that puts an emphasis on introducing accountability into the system. Thus, a set of three draft Acts sent to Parliament in 2003[49] allow both mandatory and voluntary cover, introduce a regulatory framework for health insurance, transform health insurance companies into joint-stock companies and define a basic benefit package covered by mandatory health insurance. Service providers are to sign a contract with insurance companies that are expected to compete for insurees, and competitive pressure is to ensure accountability of both service providers and insurers. As for patients, co-payments have been introduced to discourage frivolous visits to doctors. Private insurance could cover the services excluded from the basic package as well as extra services such as a faster access to elective surgery and better amenities in hospitalisation. The introduction of private insurance is in part to eliminate the long-standing practice of informal payments to doctors to gain a privileged access.

Assuming that the implementation of this reform will effectively cap mandatory health care expenditures by the revenues of health insurance companies, the latest pre-accession economic programme (PEP) projected balanced health accounts during the period 2004-2006. There are, however, several risks to this projection. First, experience in countries that have adopted a similar model of competitive social insurance shows that expenditure control is likely to be less effective than desired.[50] Second, this is particularly so in the absence of any adjustment in care facilities that are excessive, and it remains to be seen how much the devolution of hospital ownership responsibilities to regional and local governments will contribute to such adjustment. Third, a major source of spending pressure is the catching-up of health-sector wages and prices to average levels in the economy.[51]

Recommendations

The Slovak government has responded to the rapidly growing fiscal challenges by thoroughly transforming budget institutions. This provides an opportunity to upgrade Slovakia's fiscal management to above the average and closer to the best budget techniques available in OECD countries. This ambition raises two main issues:

- Does such a transformation make immediate fiscal consolidation easier or more difficult – in other words, is there a short-term fiscal price to pay?
- Is the devolution of spending power likely to go too far and too fast relative to the professional and technical skills available at the sub-central level, thereby threatening fiscal consolidation?

It must be recognised that a thorough transformation of budget institutions will come with short-term costs. These include both administrative and learning costs, and also the budget costs of previously hidden expenditures and liabilities. Such explicit expenditures are justifiable but must be well explained to domestic and international constituencies. Notably, the second pension pillar and the fiscalisation of duty losses by public utilities are likely to increase the budget burden.

More gradual phasing-in of decentralisation is favoured by several commentators. This would indeed be a more cautious strategy. However, in the context of the political dynamics already in motion in the regions and municipalities, it may be difficult to step back from the announced measures. Several territorial and local fiscal initiatives have already been launched. In these circumstances, safeguards minimising the additional fiscal risks of decentralisation must be rapidly put in place. Notably, reinforcing the fiscal procedures applicable in regional and municipal governments, and subjecting them from the outset to strong functional and procedural audits (for instance in transportation, education and other costly public services) is required.

The recommendations below focus on specific further actions aimed at helping Slovak policymakers face these immediate challenges (Box 10).

Box 10. Recommendations for public sector reform

1. Include a spending path, defined in real terms, in the medium-term fiscal framework to be annexed to the 2005 Budget Act. This spending path must be determined on the basis of a conservative estimate of the trend growth and tax revenues.
2. The spending path should be made as binding as possible and should be communicated as a core element in the medium-term economic projections submitted to the European Union.
3. Review *all* spending programmes, including so-called "mandatory" schemes based on legislation, without limiting cost-benefit assessments to "discretionary" spending. Parametric improvements in pension, social assistance and family benefit systems should remain on the agenda.
4. Important progress was achieved on pension reform and should help moderate the medium-term pressures on the system. Target to gradually increase the standard retirement age to 65.
5. The medium-term spending objective should be based on a strategic vision of functional expenditure priorities. A functional decomposition of the medium-term expenditure path should be elaborated.
6. Diffuse a "results-oriented" culture in all budgeting, financial control and audit functions of the general government. Fully adjust the legal framework to that effect.
7. Complete cash-based budgeting and monitoring with accruals-based indicators, in all government layers.
8. Plan for spending cuts in case of revenue shortfalls after the phasing-in of the 2004 tax reform, thereby avoiding a fiscal drift similar to that seen in 2002. Select lesser priority spending items for orderly cuts in the case of such an eventuality.
9. Dedicate privatisation revenues to debt reduction and to pension reform. Endow a reserve fund for pension reform (as a buffer for the PAYG 1st pillar and, if the 2nd pillar is implemented, to alleviate its cash cost for the budget).
10. Elaborate a long-term national infrastructure development plan. Spell out network development targets in rail, road, air and waterways transportation and communications. This plan should be integrated with European network development plans.
11. Develop co-operation and co-ordination between neighboring sub-central governments for the planning of transportation, education and health infrastructures of common interest. Improve co-operation with neighboring countries for the development of cross-border transportation networks.
12. Clarify the respective contributions of European, national, sub-central and private (including PPP) participants to the realization of the network plans.
13. Address inefficiencies in state-owned enterprises by exposing them fully to the disciplines of market competition and private ownership. Separately privatise the freight arm of the railways company to a qualified international operator and promote competition in rail passenger services.

Box 10. **Recommendations for public sector reform** (*cont.*)

14. Adjust capacities in public services (facilities and staff levels) proactively, according to service and infrastructure availability targets. Do not rely on *ex-post* adjustments from budget cuts (these lead to unintended infrastructure attrition and adverse selection in the quality of employees).
15. Use part of the budgetary scope created by government employment adjustments to raise wages and bonuses so as to be able to retain and recruit high-quality staff. Make the creation of new job positions more transparent and improve co-ordination between ministries.
16. Clarify the new public employment regime and fully enforce the provisions of the new State and Civil Service Laws. Make sure that the vicious cycle of low wages, low motivation and low performance in public services is overcome by cuts in excess employment and better remuneration.
17. Provide re-training to motivated civil servants with obsolete skills. This must be a priority in public sector reform and effective programmes should be protected from budget cuts.
18. In the areas where municipal fragmentation generates supply inefficiencies, provide incentives to consolidate services through amalgamation at inter-municipal or regional (VUC) level.
19. Introduce competition and apply the "money follows the user" principle in fiscally funded services. Allow for competition between national and regional agencies, not-for-profit institutions and commercial providers. Minimise distortions to competition arising from ownership differences.
20. Help equip sub-central governments with professional skills in medium-term budgeting, programme budgeting, accrual accounting, and results-oriented auditing and self-auditing.
21. Loopholes should not be permitted to arise in the integrity of the payment and procurement system as a result of decentralization reforms. Procurement, financial control and audit capacities should be strengthened in all sub-central governments.
22. Sub-central government accounts should be made fully transparent and newly-prescribed sub-central budget rules should be fully enforced.
23. Define minimum quality standards in constitutionally guaranteed services and monitor sub-central compliance while avoiding micromanagement. Make the disbursement of central government grants and possible shift to untied grants conditional upon successful compliance by sub-central governments with these standards.
24. Set up a legal framework conducive to functional, results-oriented auditing in all public spending areas, at central and sub-central levels. Fund academic, private and sub-central programme auditing institutions and projects. Make their findings widely available.

IV. Structural reforms for enterprise and job creation

Slovakia has implemented two important rounds of structural reforms in the past five years. First, following the 1998 elections, which put an end to a period of dirigisme and international isolation, key liberalisation reforms resulted in growing inflows of foreign direct investment and large-scale industrial restructuring, triggering a significant improvement of trend productivity growth. There was a strong increase in unemployment during this period, notably among low-skilled workers, while wages remained lower than in comparable OECD transition economies, providing Slovakia with an important cost advantage. Then, following the September 2002 elections, a new government was formed, representing a modification of the previous coalition, and undertook a set of more politically demanding reforms destined to address the structural shortcomings that have hampered the evolution of a vigorous domestic business sector. These reforms are focused, on the one hand, on making the labour law and the welfare system more accommodating for productive employment and, on the other hand, on making the taxation and regulatory frameworks more supportive of new enterprise creation and business sector development. These reforms require enhanced managerial capabilities in the public sector and "cultural" changes in law- and rule-enforcement so as to make the formal regulatory framework fully reliable.

This chapter reviews the progress made in reforms, describes the remaining structural weaknesses and institutional shortcomings and evaluates the policy responses to previous OECD recommendations, summarised in Table 21. Some legal and regulatory issues that are relevant to the smooth functioning of product markets and to new enterprise creation, including the quality of law and rule enforcement, are addressed first. The progress achieved in reforming the banking, insurance and capital markets is then reviewed. The chapter next discusses the evolution of employment and unemployment patterns as well as the labour code and welfare reforms that aim at facilitating employment creation and making growth more job-rich. Finally, sustainable development issues, including climate change, air pollution and the provision of a sustainable retirement income for the elderly, are analysed.

Table 21. **The implementation of OECD recommendations**

A number of specific structural recommendations were made in the previous *Economic Survey* that was published in June 2002. A brief evaluation of the actions since taken by the Slovak authorities is presented below.

Key issues/2002 recommendations	Action taken	Assessment	Follow-up recommendation
		Panel A: Product markets	
Follow through on the privatisation of the remaining state-owned enterprises.	Privatisation continued at a slow pace.	Recommendation was partly implemented.	Continue with the privatisation process.
Consider selling part of the 51 per cent share still held by the government in such companies as SPP and Transpetrol to the strategic investors who have already management rights.	To be implemented on a case-by-case basis. The strategic companies act was amended to allow for this approach.	The amendment to the strategic companies act is welcome. Evaluate carefully the economic benefits and costs of sales of the residual state-owned stakes.	Continue with the implementation.
Accelerate rationalisation of Slovak Railways, including reductions in labour costs and the closure of some lines.	The railway company was split into an infrastructure agency and a state-owned corporation for rail freight and passenger services. Marginal rationalisation of the network and modest employment cuts took place.	Recommendation was partly implemented. The rail infrastructure agency permits entry of alternative operators but only one minor passenger services firm has taken advantage of the liberalised regulatory framework.	Consider splitting the railway corporation into independent freight and passenger entities. Then the profitable freight operation could be privatised while the passenger corporation should receive only the subsidies necessary to fund its formal public service obligations.
Simplify regulations and administrative procedures for starting new companies.	The government prepared new legislation that would considerably simplify and shorten the entry process.	To be implemented in 2004.	Implement the new legislative framework as soon as feasible.
Ensure that the Anti-Monopoly Office (AMO) has the independence and resources necessary to implement the 2001 Competition Act, which brings the legal framework in line with EC directives.	According to the Competition Act, the Antimonopoly Office is an independent authority and the government ensures sufficient budgetary resources for its activities.	Partly implemented.	Continue with the implementation of the Competition Act.

Table 21. **The implementation of OECD recommendations** (*cont.*)

A number of specific structural recommendations were made in the previous *Economic Survey* that was published in June 2002.
A brief evaluation of the actions since taken by the Slovak authorities is presented below.

Key issues/2002 recommendations	Action taken	Assessment	Follow-up recommendation
	Panel A: Product markets		
Use the RONI to enhance competition in the recently privatised energy industries.	The set of the users eligible to choose alternative suppliers expanded slowly in line with minimum EC requirements.	Partly implemented.	Keep implementing the recommendation and consider accelerating the liberalisation process beyond the minimum EC requirements.
Monitor the qualification criteria imposed by professional and business groups to ensure that they do not act as entry restrictions.	A draft law aims at eliminating mandatory membership in 17 of the 28 professional chambers	Submitted to Parliament.	Implement the initial recommendation.
Enforce the 2002 Commercial Code, including its provisions on rights of minority shareholders.	Mandatory buyout rules were enforced by the regulator but the process was sometimes associated with apparent price manipulations.	Implemented.	Keep improving the professional expertise of the Financial Market Supervision staff so that insider trading and price manipulation can be detected and corrective action taken prior to mandatory buyout of minority shareholders.
Improve the bankruptcy framework, in part by granting greater rights to creditors, in order to promote more efficient liquidations, facilitate industrial restructuring and enhance financial discipline.	The government approved a new legislative framework for bankruptcy and settlement that remains to be approved by Parliament. The draft legislation addresses the weak points of the current bankruptcy framework.	To be implemented in 2004.	Assure a swift and competent implementation of the new Bankruptcy and Settlement Act.
Expand the institutional capacity of the judiciary system to handle bankruptcy cases and impose greater transparency, accountability and predictability in the system.	The new Bankruptcy Act strengthens the position of major creditors and imposes effective supervision of trustees. It limits the involvement of the courts in the approval of large voluntary settlements, facilitating out-of-court settlements.	To be implemented in 2004.	Improve the training of the judges and the selection of trustees for bankruptcy management.

Table 21. **The implementation of OECD recommendations** (*cont.*)

A number of specific structural recommendations were made in the previous *Economic Survey* that was published in June 2002. A brief evaluation of the actions since taken by the Slovak authorities is presented below.

Key issues/2002 recommendations	Action taken	Assessment	Follow-up recommendation
	Panel A: Product markets		
Develop a good business climate and enhance labour market flexibility to attract greater amounts of greenfield foreign direct investment.	The authorities reformed the corporate tax system, provided attractive FDI incentives, improved promotional activities and amended the Labour Act in a manner that permits businesses to hire more workers.	Partly implemented and further labour market reforms are scheduled for 2004.	
	Panel B: The financial sector		
Continue financial-sector reforms to improve private borrowers' access to credit.	The privatisation of banks and growing competition in the banking sector resulted in better access to credit by viable borrowers.	Implemented.	
Strengthen prudential supervision of banks and capital markets.	Financial Market Authority and the Banking Supervision will be merged under the auspices of the Central Bank.	To be effective in 2006.	Include the prudential supervision of the pension funds in the mandate of the integrated surveillance unit.
Implement the Securities and Investment Services Act to improve the non-bank financial sector, in part by closing the companies operating pyramid schemes.	Financial Markets Supervision Authority closed the companies operating pyramid schemes and tightened rules.	Implemented.	
	Panel C: Labour markets		
Streamline social programmes to increase transparency and the ability to control expenditures.	The government approved draft legislation that streamlines social programmes and improves expenditure control mechanisms.	To be implemented in 2004.	

Table 21. **The implementation of OECD recommendations** (*cont.*)

A number of specific structural recommendations were made in the previous *Economic Survey* that was published in June 2002.
A brief evaluation of the actions since taken by the Slovak authorities is presented below.

Key issues/2002 recommendations	Action taken	Assessment	Follow-up recommendation
		Panel C: Labour markets	
Ensure that social assistance to working-age people focuses on putting people back to work, in part through the introduction of activity-tested income support.	Job-seeking activity of registered unemployed was subjected to regular checks in 2003, while the benefits of able-bodied working age citizens unemployed "for subjective reasons" were cut.	Further labour market and welfare reforms are scheduled for 2004 to reward work (such as providing part of welfare benefits in form of tax bonuses).	Accompany the reinforcement of labour supply incentives by stimulating labour demand through social contribution cuts or targeted employment subsidies.
Tighten eligibility conditions for sickness benefits and their generosity.	The abuse of the sickness benefit scheme by the registered unemployed increased considerably in response to stricter checks on their job-seeking performance.	A reform of the sickness benefit system shifts the cost of the first ten days of sick leave to employers.	No further action required.
Improve public job placement services while increasing the use of private agencies.	The new welfare legislation submitted to Parliament should improve both public and private placement services when implemented.	To be implemented in 2004.	Implement pilot projects to test the abilities of commercial job placement services.
Involve enterprises in the design and funding of training programmes.	No action taken.	Not implemented.	Provide incentives to regional governments to enhance vocational school curricula in co-operation with local businesses.
Monitor closely the effectiveness of active labour-market programmes.	National Labour Office evaluates regularly the effectiveness of ALMPs, using up-to-date methods.	Implemented. Results reveal limited success of the programmes.	Fund the re-training programmes on a competitive and "money follows the student" basis.
Upgrade the education and training systems.	A new Law on Universities transforms them into autonomous institutions. The ownership of secondary and primary schools decentralised to regional and municipal governments.	University Law a positive first step. Consequences of the school decentralisation on the quality of primary and secondary education still unknown.	Facilitate the establishment of private universities. Phase-in a student loan system. Monitor the performance of decentralised primary and secondary schools.

Table 21. **The implementation of OECD recommendations** (*cont.*)

A number of specific structural recommendations were made in the previous *Economic Survey* that was published in June 2002.
A brief evaluation of the actions since taken by the Slovak authorities is presented below.

Key issues/2002 recommendations	Action taken	Assessment	Follow-up recommendation
	Panel C: Labour markets		
Expand the proportion of students entering tertiary education.	Universities' capacities were slightly improved but half of the applicants will still be turned down in 2003/2004. A draft law prescribes fees in tertiary education to increase available funding.	Draft law is a positive first step. Tertiary education capacity in the most demanded branches remains insufficient.	Adopt the draft law. Ensure that academic committees do not slow down but facilitate the adaptation of the programmes and services.
Adapt curricula of vocational schools to the needs of enterprises.	The ownership of vocational schools decentralised to regional governments.	Decentralisation should facilitate the co-operation of vocational schools with local businesses.	Monitor the experiments of decentralised vocational schools. Make transparent the comparative performance of regional vocational school systems.
Eliminate the extension of collective agreements to firms not involved in the negotiations.	Government policy is to extent agreements only upon written consent by the firms concerned.	The new policy is a positive step. However, it is not made permanent through legislation.	The recommendation remains pertinent.
Decentralise wage bargaining to allow agreements to better reflect conditions at the firm level.	The Labour Code constitutes firm-level bargaining as the primary form of wage determination. Elimination of automatic extension of collective agreements to firms not involved in the negotiations strengthens the role of firm-level bargaining.	Not implemented.	The recommendation remains pertinent.
Relax employment protection provisions in the labour code.	The amended Labour Code relaxes employment protection rules.	Implemented.	No further action required.
Ease regulations on working time.	The amended Labour Code eases regulations on working time.	Implemented.	No further action required.
Revise the labour code to reduce the excessive power of trade unions in management and compliance issues.	Accomplished by the amendment to the Labour Code.	Implemented.	No further action required.

Table 21. **The implementation of OECD recommendations** (*cont.*)

A number of specific structural recommendations were made in the previous *Economic Survey* that was published in June 2002.
A brief evaluation of the actions since taken by the Slovak authorities is presented below.

Key issues/2002 recommendations	Action taken	Assessment	Follow-up recommendation
		Panel C: Labour markets	
Remove the rule requiring new owners of firms to honour existing agreements with the workforce.		Implemented.	No further action required.
		D. Public sector	
Remove distortions in the housing market.	Regulated rents were increased sharply but the market for rental housing remains underdeveloped.	Partly implemented. Rental housing development by the private sector is still slow.	Facilitate rental housing development by the private sector.
Improve the transport system.	Except for the start-up of new airline services from Bratislava and Banska Bystrica, no noticeable improvement of the transport network took place.	Implemented only to some extent in the air transport. Funds for highway development have been increased but maintenance backlogs in the road network get larger. No improvement in railway services despite reform efforts.	Explore opportunities for private investment in the road network. Privatise rail freight services as a separate company. Encourage new entries and competition in rail passenger services.

Source: OECD.

Product markets

The environment for doing business

The business environment can be characterised by its degree of openness to competition and entrepreneurship, the protection of property rights, and its vulnerability to corruption and fraudulent expropriation. The indicators in Table 22 refer to the situation in the early 2000's when the quality of Slovakia's business environment continued to lag clearly behind that of comparable small open economies in Europe. The government formed after the September 2002 parliamentary elections responded to this challenge by launching a series of structural reforms aiming to improve the legal environment, to enhance labour market flexibility and to reduce the tax burden. These reforms will tend to help modernise market institutions in Slovakia and make it possible for the country to establish solid foundations for long-term growth.

Legal environment

The weak legal environment is perceived as a major problem by the business community (PAS 2002). Complaints concern the instability and ambiguity of legislation, poor and slow enforcement of law, including for the registration of enterprises, and endemic corruption. According to public perception surveys, corrupt practices are widespread at the interface of the public and private sectors; the "supply" of favourable court decisions, lucrative privatisation contracts, rigged public procurement tenders, state guarantees, licences, registrations and subsidies being generated by officials and their agents in response to "demand" by businesses, made effective by cash.[52] There are reports that some of these transactions

Table 22. **Economic environment indicators**
[The most supportive environments are ranked highest]

	Perceived corruption	Economic Freedom	Growth competitiveness	Business environment
Finland	1	2	1	1
Austria	2	3	2	3
Ireland	3	1	4	2
Portugal	4	4	3	4
Hungary	5	6	5	7
Greece	6	7	6	8
Poland	7	8	9	6
Czech Republic	8	5	7	5
Slovakia	8	8	8	9

Source: OECD Secretariat, on the basis of Transparency International (2002), Heritage Foundation (2003), World Economic Forum (2003), Economist Intelligence Unit (2003).

finance party contributions, subverting the political process. Despite repeated government initiatives over the last 5 years to combat corruption and penalise the culprits, inherent weaknesses in both legislation and implementation meant that few cases could be prosecuted and there were hardly any convictions.[53] One part of the problem is the court system that burdens judges excessively with routine administrative work.[54] Another part is the malfunctioning appeals process that allows higher courts to simply return disputed cases to lower courts rather than mandating them to either dismiss or make substantive rulings.[55] Last but not least, the domestic business culture has had weak roots in ethical principles until now,[56] and the cultural values of an open modern society take hold only slowly.[57] These institutional shortcomings increase transaction costs and reduce productivity. However, the new government has decided to make judicial reform and fight against corruption a key priority of the current legislature (Box 11).

The administrative barriers to *business creation and entry* are still unnecessarily high. Illicit payments reportedly take place to quicken the registration process. The new legislation that is expected to be implemented in 2004 should shorten this process to at most 5 business days.[58] The *exit* of non-viable firms continues to be plagued by a dysfunctional bankruptcy system (Box 12). The massive backlog of over 7 000 unfinished cases slows down the reallocation of resources trapped in loss-making activities. Given that a sizeable share of total employment is located in vulnerable public and private sector activities,[59] the acceleration of the resource reallocation process is critically important. The government intends to improve the situation by a new Bankruptcy Act that is to be implemented in 2004. Further, the Ministry of Economy has been entrusted with the task of analysing the functioning of market institutions, including the entry and exit mechanisms, with the aim of proposing a series of policy measures to improve the environment for doing business. To date, this is work in progress.

Small-scale domestic entrepreneurs suffer from inadequate protection of property rights. Whereas local subsidiaries of multinational firms can protect their own interests adequately and often enjoy additional protection provided by international bilateral investment agreements, smaller businesses have been more vulnerable to date to the infringement of their property rights and to exploitation by unscrupulous officials and organised crime. The ongoing alignment of the legal codes with the *acquis communautaire* is beneficial in principle but the administrative capacity to implement the new legislation still appears insufficient. If the legal reforms proceed as scheduled by the government, the court system is expected to function properly by 2006.[60] Once the courts are able to operate effectively, the enforcement of their decisions will also need to improve for fuller reliability of the judicial system.

Effective law enforcement will also mean that the full application of the EU-compatible environmental legislation, with its cost-increasing effects (see section

Box 11. Public perceptions of corruption

In spite of major progress in market liberalisation and modernisation of economic institutions, perceptions of abuse and corruption in the conduct of public affairs, in the enforcement of laws, and in public procurement and other official economic activities persist.[1]

No statistical data exist on these malpractices, other than the number of cases taken to court and the number of convictions, which almost certainly grossly understate the magnitude of the problem.[2] In contrast, there are several sources of data on the *public perceptions of the incidence of corruption* and they all point in the same direction: corruption appears to be widespread, more so than in other post-transition OECD countries, has not significantly declined in recent years, and may have even increased in certain areas.

The perception data is unsettling because they point to crucial state institutions, like the justice system, the police, education, health and tax services, as being the most vulnerable to bribery and corruption. According to the latest survey carried out in 2002, 60 per cent of the Slovak citizens believe that "bribery exists and is very prevalent" in the courts and prosecution, 55 per cent has the same image of the police, and 30 per cent of the tax offices. The proportion is even higher concerning the health system where Slovak citizens seem to believe that receiving the due care without giving bribes (gratitude payments) is difficult. Entrance examinations in secondary and tertiary education institutions also appear to be vulnerable to bribes to a large extent.

Efforts to improve the credibility of public officials and fight fraud have been on the government agenda for several years. A number of policy papers and statements have been issued, but little concrete action has been taken. One reason may be that bribery and corruption in public affairs is not unrelated to party financing. Another factor has been the attitude of professional bodies, including in the justice and education systems, tending to bury cases and obfuscating inquiries and prosecutions. The lower level of wages in the public sector for skilled employees in comparison to more attractive private sector salaries provides a favourable environment for corruption.

There are nevertheless some promising new developments. The very first inquiries on corruption cases in the judiciary have been undertaken in 2002. Civil society organisations against corruption became more vocal, an "Alliance to Stop Conflict of Interest" gathering 240 non-governmental organisations proposed jointly "Seven Principles for Adopting a Stricter Law on Conflict of Interests" and the local branch of Transparency International issued legislative proposals in the form of an "Anti-Corruption Minimum". After the rejection of a new constitutional law against Conflicts of Interest in the Public Sector in 2001, it is to be hoped that the government will succeed in passing new legislation in this area, which could be developed at the same time as a new and fully enforceable legislation on party financing.

1. Detailed reviews of available statistical information and of the initiatives to fight corruption can be found in Transparency International 2002, Prochazka *et al.* 2003, and Zemanovicova *et al.* 2003.
2. According to court statistics, between January 1999 and June 2001 49 perpetrators were convicted for corruption, 32 for bribery, and 24 for accepting bribes and other undeserved advantages.

Box 12. Improving the bankruptcy process

The 1991 Act on Bankruptcy and Composition has been revised numerous times. Until the late 1990s, delayed restructuring meant that bankruptcies were relatively rare and settlements almost non-existent. Subsequently, the number of bankruptcies almost doubled from 1 289 completed cases in 1999 to 2 452 in 2002. The number of settlements also increased from 4 completed cases in 1999 to 26 in 2002. These operations can only be proposed by debtors and are rarely acceptable to creditors. Although the law provides for a creditor-centred bankruptcy system, its application by three specialised regional courts seems to have often favoured debtors instead.

The current bankruptcy legislation favours the sale of the bankrupt firm as a going concern, either as a whole or piecewise. Bankruptcy court judges play an important role in this process, declaring bankruptcy that can be proposed either by debtors or creditors, calling the initial meeting of the creditors' committee, supervising the process to ensure that transactions take place at the arm's length, etc. The creditors' committee appoints the trustee and approves his/her restructuring or liquidation programme, subject to endorsement by the judge. The court-appointed trustees are typically lawyers with limited managerial experience and rudimentary economic education who are selected through non-transparent procedures by courts. Nevertheless, the remuneration of these trustees is lucrative and considerably exceeds the salaries paid to judges.[1] Committees are typically dominated by one or more large creditors while the majority of creditors have no influence on the process. However, if the administrator colludes with the judge, then it is possible to neutralise even major creditors on spurious grounds.[2] In larger bankruptcy cases, a few domestic financial groups that have specialised in trade with receivables co-operate with legal firms, consultancies and the Slovak Consolidation Agency, to acquire key assets for resale.

The current legislation was supposed to encourage the entry of large foreign investors; however, they have usually preferred to launch greenfield projects benefiting from significant investment incentives rather than taking over bankrupt entities.[3] Instead of sales to foreign investors, the still non-transparent bankruptcy proceedings resulted in a number of cases in heavily discounted purchases of bankrupt firms' receivables by their former owners.[4] Over the last five years, 20 out of the 100 largest Slovak firms went bankrupt; their successors appear to be controlled by the original owners. Although by no means certain, it is possible that this kind of financial restructuring explains the continued weakness of the domestically owned business sector. It is unclear whether the once ineffective owners, who acquired productive assets in the wild privatisation of the early and mid-1990s, have become better managers in the meanwhile.

The authorities responded to the apparent lack of transparency by switching to a random selection of bankruptcy judges and encouraging them to report suspicious activities to the Attorney General. This led to a proliferation of bankruptcy proposals that would be withdrawn by petitioners if the randomly assigned judge was found to be "unsatisfactory". Despite frequent allegations of misconduct, sometimes made publicly by the bankruptcy judges supervising specific

Box 12. **Improving the bankruptcy process** (*cont.*)

cases, only a handful of criminal proceedings have been launched, the outcomes remaining highly uncertain given the limited resources available to prosecutors and the complexity of the transactions investigated.

The government intends to overhaul the existing legislation with a new Act. The new legal framework strengthens the position of major creditors and imposes effective supervision of trustees, while limiting the involvement of courts in the final approval of large compositions. It thereby facilitates out-of-court settlements. In contrast to the current situation, creditors would also be entitled to propose settlements. This new Act is to become effective in 2004.

1. The average monthly wage of the court judges was SKK 34 000 (€ 850) in 2001. According to official statistics which tend to underestimate the remuneration of private sector employees, this is lower than SKK 39 000 for general managers and SKK 67 000 for company directors.
2. See "alia vlna privatizácie", Hospodárske noviny, 13 August 2003.
3. The much heralded purchase of the core business of the bankrupt glass producer Skloobal by the Swiss Vetropack holding group in 2002 is an exception rather than a typical outcome of the bankruptcy process. In this case, the bankrupt firm had a valuable production technology, skilled manpower and traditional markets that could be put to good use once separated from ineffective owners who acquired control in an obscure management buy-out in the 1990s.
4. See Trend, 29 May 2003.

below on Sustainable Development), will hit locally-owned businesses more than the FDI firms that have already made their environmental compliance investments. This costly challenge can be met with wider utilisation of market-based environment-protection instruments (such as tradable emission permits), but the already very busy reform agenda and budgetary and human resource constraints have not yet permitted a government initiative in this area.

More generally, the full enforcement of the legal, regulatory and tax rules will require adaptation by unregistered businesses. According to official estimations, undeclared employment represented about 150 000 workers in 2001 – more than 7 per cent of total employment. According to another estimate, unregistered businesses generated value added amounting to roughly 10 per cent of GDP in 2001. While a marginal part only of unregistered businesses seem to operate in illegal activities, most of them provide inputs, but also competition, to the formal sector. With overall improvement in law enforcement and tax collection, more of these operations will need to join the formal sector. The heaviest burden for them will be the payment of social security contributions representing close to 50 per cent of total labour costs. It is not clear which part of the undeclared activities might become non-viable if made fully subject to this liability. In the tax area, the government plans to abolish the special lump-sum tax for small businesses with a turnover below SKK 2 000 000 (€ 50 000) and to replace it with the standard corporate tax rate of 19 per cent. If implemented, this measure should be expected to increase the tax liability and the compliance costs of many small businesses.

Foreign direct investment and privatisation

Between 1999 and 2001, the authorities created a comprehensive legal framework for investment promotion, focussing on the projects exceeding the SKK 1 billion (€ 25 million) threshold.[61] Prodded by these incentives, privatisation-related and greenfield FDI inflows have played an increasingly positive role in the transformation of the Slovak economy (see Figure 6 above and Table 23). However, five of Slovakia's investment promotion measures are considered harmful by Brussels and may have to be phased out prior to the country's accession to the EU in May 2004. Given the fact that its principal regional competitors for FDI inflows will be subjected to similar treatment and that it has a large cost advantage over the current EU members, Slovakia should be able to keep attracting significant FDI inflows in the near future. New greenfield investment may well be provided by the multinational car component producers drawn to the country by the success of the large Volkswagen factory in Bratislava and the decision of PSA Peugeot Citroën to build a plant with comparable capacity (300 000 automobiles per annum) in nearby Trnava. Also, the stream of smaller investments from Western Europe and overseas, resulting in takeovers of medium-sized national firms, may provide another important source of economic modernisation. The geographical location of inflows is also likely to change as investors become increasingly attracted to high-unemployment regions where incentives are significantly more generous and cheap low-skilled labour plentiful.

The FDI stock should increase considerably when the government sells a large stake with management rights in the dominant power generator (Slovak

Table 23. **Foreign direct investment inflows**

	1995	1999	2000	2001	2002	Cumulative 1990-2002[1]	Cumulative per capita
	US$ million						US$
Slovakia	230	403	2 154	1 271	4 009	9 631	1 783
Czech Republic	2 562	6 326	4 980	5 645	8 436	35 916	3 497
Hungary[2]	4 810	3 496	3 530	4 473	3 354	34 857	3 411
Poland	3 659	7 270	9 342	5 713	4 082	50 552	1 308

1. 1993-2002 for Slovakia and the Czech Republic.
2. OECD estimates of reinvested earnings were used to derive a comparable time series for Hungary.
Source: OECD international direct investment database and national sources.

Electricity Company or SE). The open tender for acquisition of control over SE has been called and ought to be completed by the end of 2003 with the sale taking place in 2004. To date, the authorities have not decided whether to privatise SE as a whole or only its non-nuclear plants. The sale is subject to the restriction on foreign ownership in strategic firms that would limit the prospective investor to 49 per cent of shares. While the government is generally supportive of the idea that private enterprise ought to play a decisive role in the economy, it keeps significant stakes and influence in a small group of strategic companies.[62] Other candidates for privatisation include the state-controlled regional bus companies, Slovak Airlines, and the country's airports (that are to be sold to private operators within a year or two). In contrast, the authorities have decided to renationalise an arms producing factory, instructing the state-controlled DMD holding to acquire this facility during the ongoing bankruptcy process of the parent conglomerate (ZTS Dubnica). While the aim of keeping alive a national heavy engineering firm and the associated skills and traditions is understandable and by no means unique to Slovakia, the government ought to justify it to the public with a clear comparison of costs and benefits.

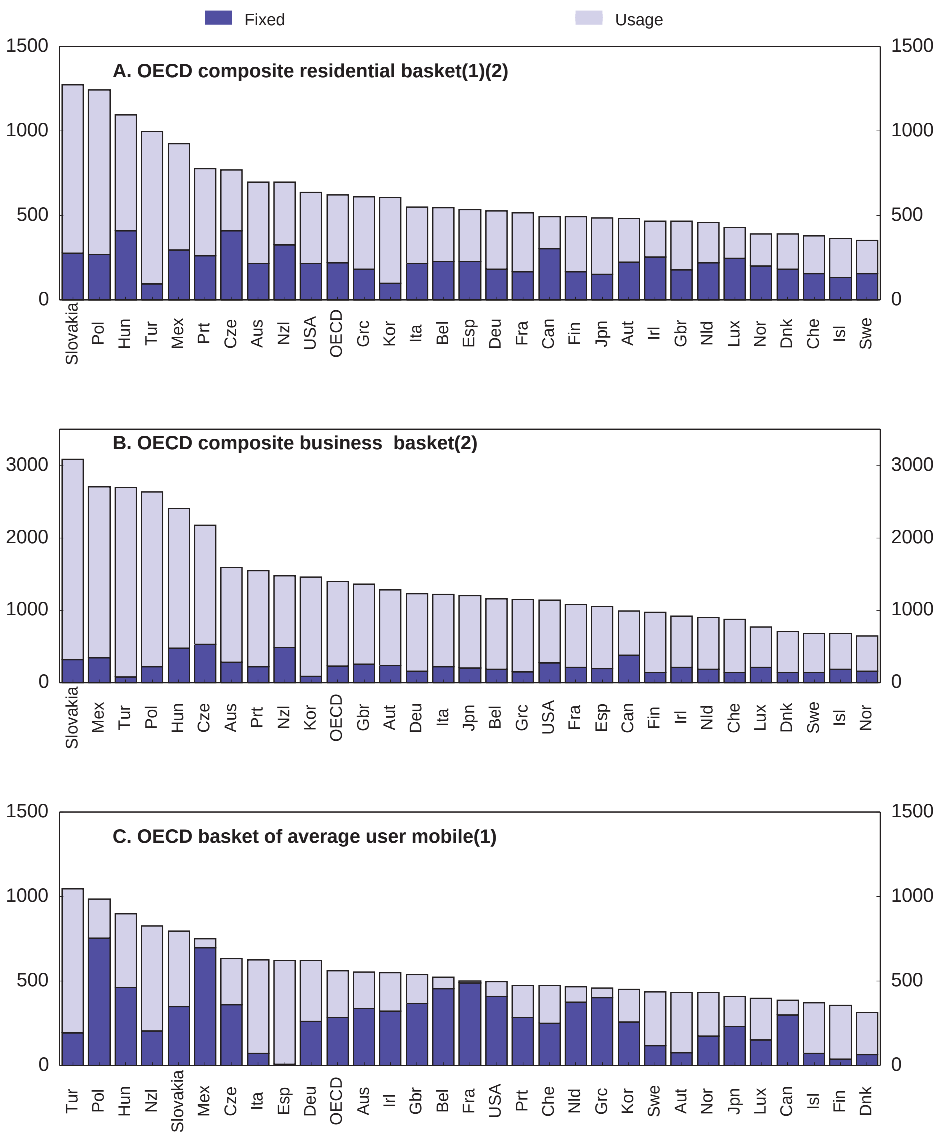
Network industries

Telecommunications

Slovakia's users of telecom services face some of the highest tariffs in the OECD area on a purchasing power parity basis (Figure 18). At the same time, and at least partly reflecting the level of connection tariffs, Slovakia lags most OECD countries in the diffusion of internet services (Figure 19). Although there are a dozen alternative small operators with fixed-line telephony licences, only the incumbent (Slovenské telekomunikácie (ST), controlled by Deutsche Telekom) provides comprehensive services (local, long distance and internet) to all users. The mobile telephony market is a duopoly with licences held by Eurotel (Deutsche Telekom) and Orange (France Telecom). There are promising but still marginal new entries in higher-technology broadband and cable telecommunications. The terms of the privatisation contract of the dominant fixed-line operator, and the regulatory weaknesses resulting from both incomplete legislation and limited technical experience of the regulator (Telecommunications Bureau) may be limiting the applicability of competition principles according to the EC Directives. Notably, the "last mile" issue, whereby the incumbent operator which controls the interconnection to households and offices can impose anti-competitive access and pricing terms, is particularly acute.[63] A Telecommunications Law enforcing the EC Directives was drafted and voted by the Parliament in early 2003, enhancing the provisions for new entrants regarding interconnection, number portability etc., but the telecommunications incumbent strongly opposed it and the President vetoed the Law. A new vote failed in the Parliament and the draft is now stuck in

Figure 18. **Telecommunication tariffs**

August 2003, US$ at PPP

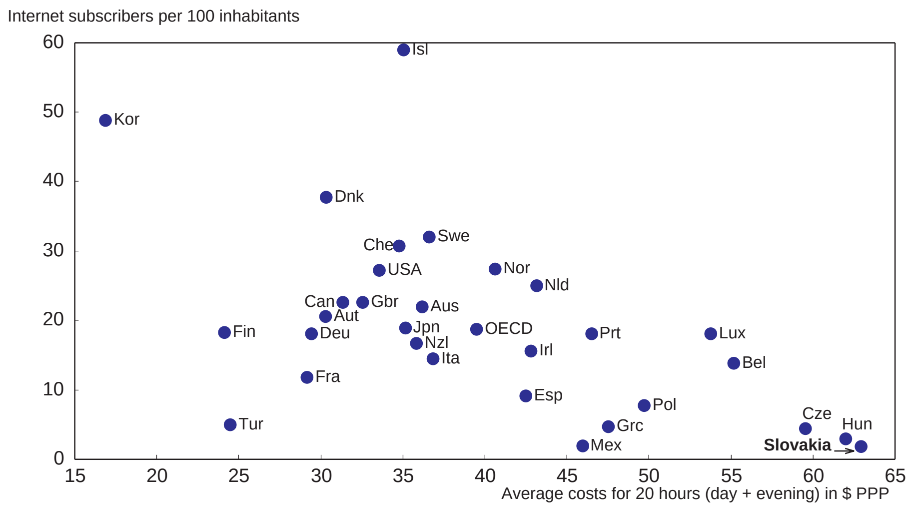


1. VAT included.
2. Calls to mobile networks and international calls included.

Source: OECD, telecommunications database.

Figure 19. **Internet access costs and diffusion**

2002



Source: OECD, telecommunications database.

the legislative process. The Association of Telecommunications Operators, which represents the new operators, recently expressed dissatisfaction with this state of affairs and made public its additional concern that, should the law be adopted, the regulator may still prove unable to enforce its full provisions in the presence of a politically powerful incumbent monopoly.[64]

The present status of the regulator as a unit of the Ministry of Transport, Posts and Telecommunications limits its independence and constrains its hiring policies. The telecommunications regulator cannot hire experienced market experts because of the provisions governing salaries in the civil service. This is likely to be the key reason why the regulator has been reluctant to date to issue controversial rulings that may be challenged in court by incumbent firms that can employ expensive legal and technical talent. Further, the regulator is prevented from imposing the interconnection charges based on long-run incremental costs (the state-of-the art tariff methodology) because the current Act on Prices does not allow it. The regulator also cannot assure the effective implementation of the "number portability" provision of the Telecommunications Act because it is not authorised to force the incumbent to reach agreements with competitors. In mobile telephony, the government was unable to sell a third operating licence to foreign investors because they demanded full interconnection with the incumbents' networks, to no avail. The winning little-known domestic bidder went bankrupt before it could pay the comparatively low licence fee (about $40 million).[65] The mobile communications market therefore remains a duopoly.

Energy

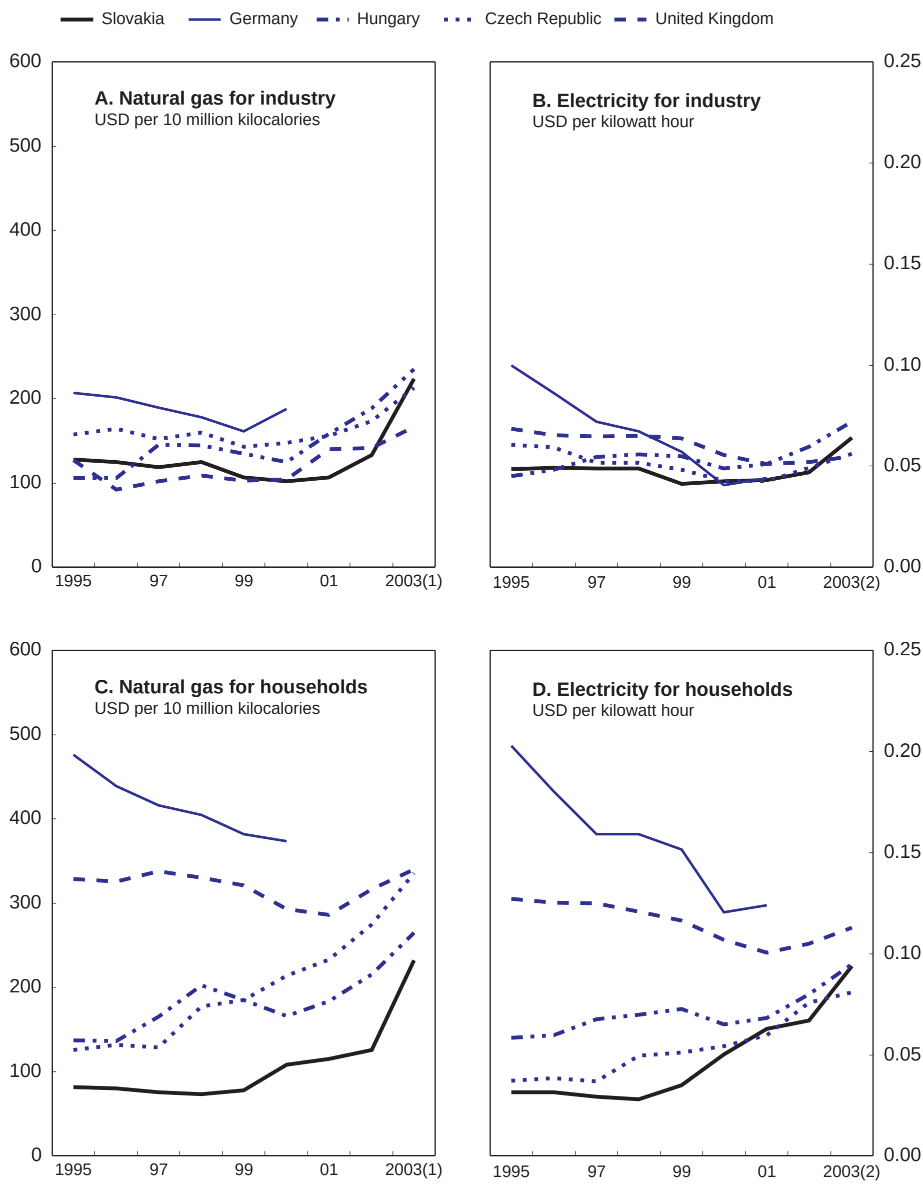
Until 2003, both industrial and household users have been paying subsidised and moderate energy prices, irrespective of costs and efficiency in energy production and distribution. An accelerated shift to cost-based pricing and efficiency-enhancing competition started in 2003, following EU guidelines, in both electricity and gas markets. In electricity, large industrial users[66] have been entitled to select their suppliers, at freely negotiated prices and including from abroad, from January 2003. Medium-size users[67] have obtained the same right from January 2004 and this will be widened to all industrial users in January 2005. Households will freely chose their generator only after 2007. In the gas market, which has been traditionally more subsidised even than electricity, the first and biggest adjustments concern pricing. Industrial users started to pay cost-recovery level prices in 2003 and this will apply to households in 2004 (Figure 20).

Starting from January 2003, the Energy Regulator (RONI) regulates the tariffs of all natural monopolies of transmission and distribution in the energy sector. However, it cannot set quality standards for services. Although many large-scale firms have favourable long-term contracts with incumbent providers, they support the liberalisation process which provide them with an opportunity to re-negotiate their contracts according to market circumstances and alternative supply offers. In retail markets however, and although sales of 49 per cent of government stakes in regional distributors to strategic investors have increased their productive efficiency following reorganisation and layoffs, consumers have not yet reaped any resulting benefits.[68] Following more complete privatisation in the energy sector and as prices converge toward cost-recovery levels, RONI will have to monitor the price outcomes in different market segments and to ensure that competition works and users reap benefits. To make the competitive procurement of energy fully effective, open and fairly priced access to transmission and distribution infrastructures (electricity grid and gas pipelines) will need to be secured for all purchasers and providers, including from abroad. The energy regulator will likely face new and difficult issues in the future and must be adequately resourced in order to meet them.

The role of the competition authority

The competition authority has played an active role in supervising the introduction of competition in network industries, including in the energy sector, and in pushing the government to adopt competition-friendly forms of privatisation.[69] The authority's policy influence is institutionalised through its chairperson's

Figure 20. **Energy prices**



1. Data are for 2003 Q2 (2003 Q1 for United Kingdom).
2. Data are for 2003 Q1.

Source: International Energy Agency (2003).

regular participation in cabinet meetings and membership in the council of economic ministers. Nevertheless, the beneficial influence of the competition authority on the business environment has been reduced by certain shortcomings. The existing legislation entails overlaps found in other OECD countries between the competition authority and sectoral regulators (such as the Telecommunications Bureau and RONI) but the necessary co-operation appears less advanced in Slovakia. Furthermore, key decisions concerning abuses of market power by dominant firms have been appealed with success at the Supreme Court whose judges have no special expertise or access to professional advice in the area of competition principles.[70]

Financial markets

Banking

Following recent privatisations, the Slovak banking sector is dominated by foreign-owned banks that control some 95 per cent of assets (Table 24). After a

Table 24. **Banks: main indicators**

	1999	2000	2001	2002
	SKK billion			
Total bank assets	769.8	846.9	928.8	1 014
Total bank credits	410.2	407.3	337.9	341.5
Total reserves and provisions	113.0	105.3	92.6	56.5
Bank profits	–29.5	4.4	9.1	11.8
Growth of banks' assets (1993 = 100)				
Total credits	103.1	99.3	83.0	101.1
Securities	97.9	512.6	180.8	111.0
Other assets	78.2	135.6	149.1	123.6
Growth of credits by quality (1993 = 100)				
Standard	124.0	117.6	77.5	116.5
Classified	83.4	73.6	95.1	72.8
Watch	81.8	72.1	121.3	108.2
Sub-standard	91.0	53.9	91.4	117.2
Doubtful	125.7	67.8	68.7	52.8
Loss	79.2	77.6	85.3	44.9
Growth of credits by maturity (1993 = 100)				
Short-term	86.3	101.2	72.8	102.8
Medium-term	164.7	98.7	69.2	107.3
Long-term	85.2	97.6	113.7	94.8
Memorandum items (ratios in percentage):				
Total reserves and provisions/total assets	14.7	12.4	10.0	5.6
Total reserves and provisions/classified loans	66.1	83.8	77.4	64.9
Loss loans/classified loans	54.3	57.2	51.3	31.7

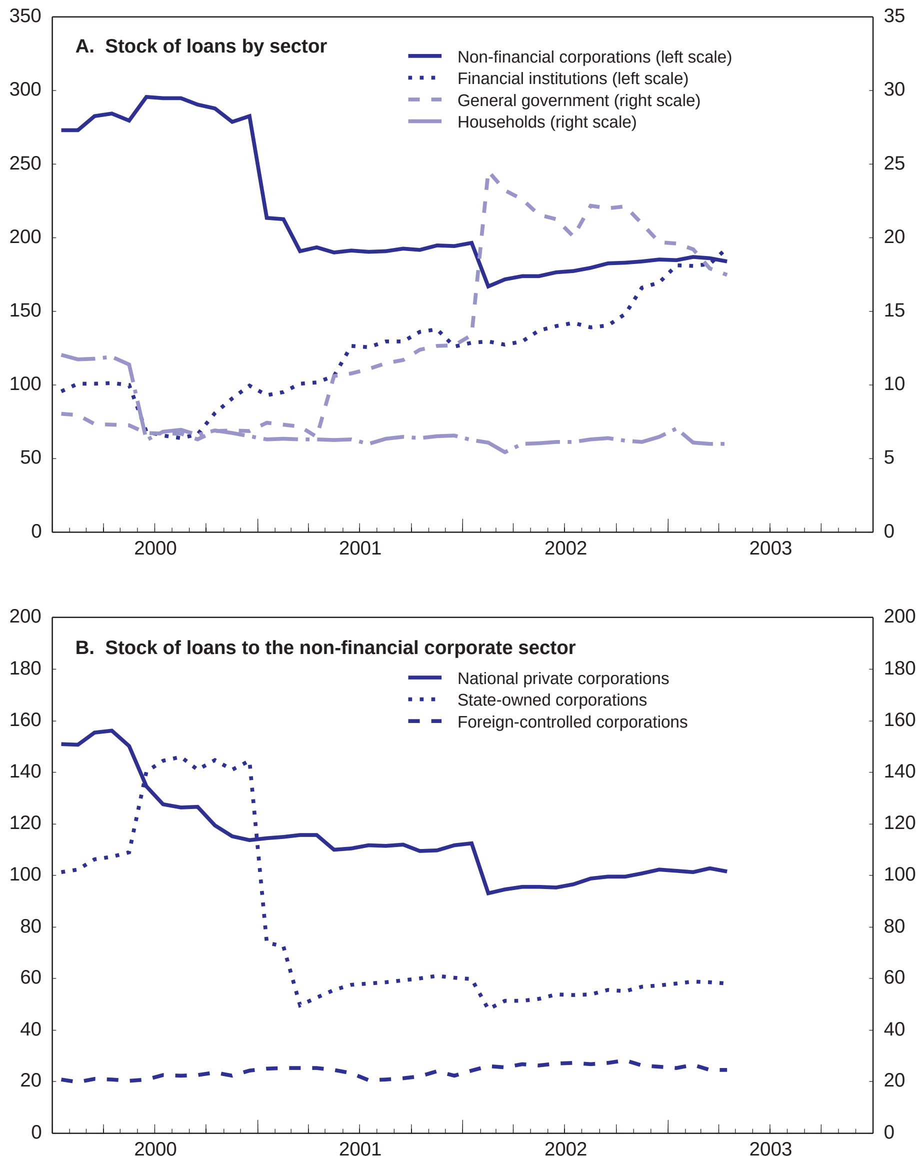
Source: National Bank of Slovakia.

period of comprehensive clean-up of portfolios, credits to enterprises grew moderately while those to households increased strongly, albeit from a very low base level (Figure 21). Credits to households were driven by mortgage loans that grew spectacularly last year, partly due to generous subsidies available to new residential owners. Given the declining spreads between interest rates on loans and deposits, profits in the private banking sector grew slowly and were mainly driven by the rising revenues from non-lending financial services. Almost all banks have hiked their fees for diverse transactions, prompting an investigation by the competition authority. The intensity of competition in the banking industry appears satisfactory in the traditional loan business but restricted in these other services. The stock of loans to the foreign-controlled businesses remains relatively modest as these firms are funded at lower costs from international markets. Nonetheless, in 2003 over 60 per cent of newly drawn loans have been absorbed by foreign-invested corporations because of very limited borrowing by domestically controlled firms.[71]

Credits to small and medium-sized enterprises (SMEs) have recorded very limited growth. Nonetheless, the prospects for SMEs to gain better access to credit have improved. Banks, including large foreign-owned universal banks such as VUB, have increased their efforts to map the industrial landscape and find new reliable customers among locally owned small firms. Like their counterparts in other transition economies, small businesses can also take advantage of loan programmes that provide the participating commercial banks with loan guarantees by the state-owned development bank and cheap funds by international institutions such as the EBRD and Kreditanstalt für Wiederaufbau. The government also introduced a "micro loans" scheme and a "seed capital" facility for new ventures, funded from EU resources. The overall volume of subsidised credits and equity capital has remained modest, however, and only 3 to 4 per cent of the total population of small businesses make use of them.[72] The decisive contribution to the creation and growth of new firms should be expected to come from the private financial sector.

Reforms to strengthen the prudential supervision of banking and financial markets are making progress. The banking sector is financially robust and the capital adequacy of most foreign establishments have reached record levels. In contrast, the credibility of the non-bank financial intermediaries has not yet been restored after the scandals of the 1990s. Banking and financial market supervision will be integrated in a single surveillance authority in the National Bank of Slovakia, through a project jointly designed by banking and financial market authorities. It should considerably strengthen the quality of financial surveillance by simplifying the inquiry ("hunting") activities, the monitoring of financial innovations involving both sectors and reducing the overall costs of surveillance. The government has approved a framework on the integrated supervision of financial markets. It should become fully operational in 2006.[73]

Figure 21. **Bank loans by sector**
SKK Billion



Source: National Bank of Slovakia.

Supervision of insurance

The Slovak insurance sector is now predominantly private and foreign owned. The takeover of the largest state-controlled insurer (Slovenská poisova or SP) by the German *Allianz* group created a dominant entity controlling just over 46 per cent of the market. This, as well as the takeover of the ninth largest insurance company (Kontinuita) by the Austrian Wiener Städtische group that already acquired two other Slovak operators (Kooperativa amd Komunálna poisova), consolidated the insurance market.[74] Following a record expansion in 2001 and the entry of new operators from abroad, the growth of the life insurance market slowed down. The growth of the non-life sector was stronger, driven by the mandatory auto insurance that was demonopolised in January 2002.

The benefits of the liberalisation of the insurance sector have been undermined by defective legislation and controversial court decisions concerning the compensation of the victims of car accidents which occurred before demonopolisation. The opening of the auto insurance business to competition resulted paradoxically in a proliferation of costly litigation and an average 50 per cent jump in premia in 2003, and a similar 35 per cent jump is expected in 2004. The compensation amounts awarded for minor injuries by Slovak courts to victims of car accidents have skyrocketed, especially in the relatively depressed eastern part of the country, exceeding now by wide margins the comparable payouts elsewhere in Europe.[75] Unlike in other countries, insurers in Slovakia could not appeal these court decisions without the agreement of the insured driver – this provision was however recently cancelled and insurers obtained a right of appeal. Since the *Allianz* group controls more than 60 per cent of the auto insurance market,[76] it would normally pay some two thirds of total compensation cost through the joint liability fund set up by all insurers. However, the privatisation contract caps the amount of contributions payable by this dominant operator and makes the government liable instead. Slovakia imposed an upper limit (of SKK 19 million) on the amount of compensation for "damage to health and costs incurred in the event of death" only from January 2002, closing the earlier loophole. If the authorities do not want to impose such limits on an *ad hoc* basis, they might want to consider setting up a no-fault scheme that would stop the abuse of the current system and reduce the premia paid by consumers.[77]

Capital markets

The development of the capital market is important notably as an avenue permitting the "exit" of venture-capital partners investing in start-up companies. The capital market was hit in 2002 by the default of a number of unlicensed deposit funds connected to 2 large pyramid scheme operators; this further eroded the already low public confidence in investing. By contrast, confidence in licensed unit trust investments seems to have grown, the net asset value of such instruments doubling between 2001 and 2002. Nonetheless, the stock market continues to be characterised by low volumes, lack of liquidity and the absence of initial public offerings. As in other countries with relatively thin markets, the improved protection of minority shareholders by means of mandatory buyouts raises risks of insider trading and market manipulation. This was illustrated in the case of the mandatory takeover bid on the energy firm Slovnaft, the largest company listed on the Bratislava stock exchange, by the Hungarian MOL group. Slovnaft's stockmarket price steeply increased (by 27 per cent) when MOL, which already held a minority stake with management rights in the company, prepared a complete takeover. MOL complained about the alleged stock price manipulation that significantly increased its costs associated with the mandatory buyout. The Financial Market Authority, after extensive investigation in co-operation with foreign supervisory authorities, did not find any wrongdoing and the disputed trade that increased the relevant reference value of the stock could not be annulled.[78] The MOL-Slovnaft case illustrates that an otherwise sound rule to protect minority shareholders may cause, in a market lacking depth and with a short history of supervision, very high price volatility and risks of market manipulation.

Despite these problems, private-equity investment has picked up. The most significant transaction taking place this year involved the takeover of Slovakafarma, the largest Slovak pharmaceutical producer, by a Dutch subsidiary of Warburg Pincus. The new owner will merge Slovafarma with a Czech counterpart (Léiva) that it already controls, aiming to create one of the largest pharmaceutical firms in the region. Other private acquisitions resulted from successful bids by domestic corporate raiders for control of heavily indebted firms such as the aluminium smelter ZSNP and the VSZ steel mill. Given the unproven track record of the domestic financial groups involved, it is difficult to judge whether these transactions will ultimately prove to be value creating.

Aside from the well developed and growing government bond market, a promising segment of the capital market is that of pension investment. There is a smoothly functioning voluntary system that is dominated by experienced foreign-owned pension funds. Tax deductibility of both contributions and benefits have made this form of investment popular. In addition, the pension reform that is under way will establish a funded pillar that will be privately managed (see Sustainable Development section below). This should result in a welcome deepening of the financial and capital markets, providing that adequate regulations protect the integrity of pension fund investment. Approximately SKK 10-15 billion (€ 350 million) worth of funds will be invested each year by competing pension trusts. It will be necessary to avoid the escalation of unrealistic return promises and unsound investment practices in this new sector. A draft supervisory framework has already been prepared, acknowledging different categories of funds with different portfolio structures and risks, with access restricted to specific categories of pension contributors.[79] The authorities should consider integrating the prudential surveillance of the pension fund industry with the newly unified financial surveillance authority under the National Bank of Slovakia.[80]

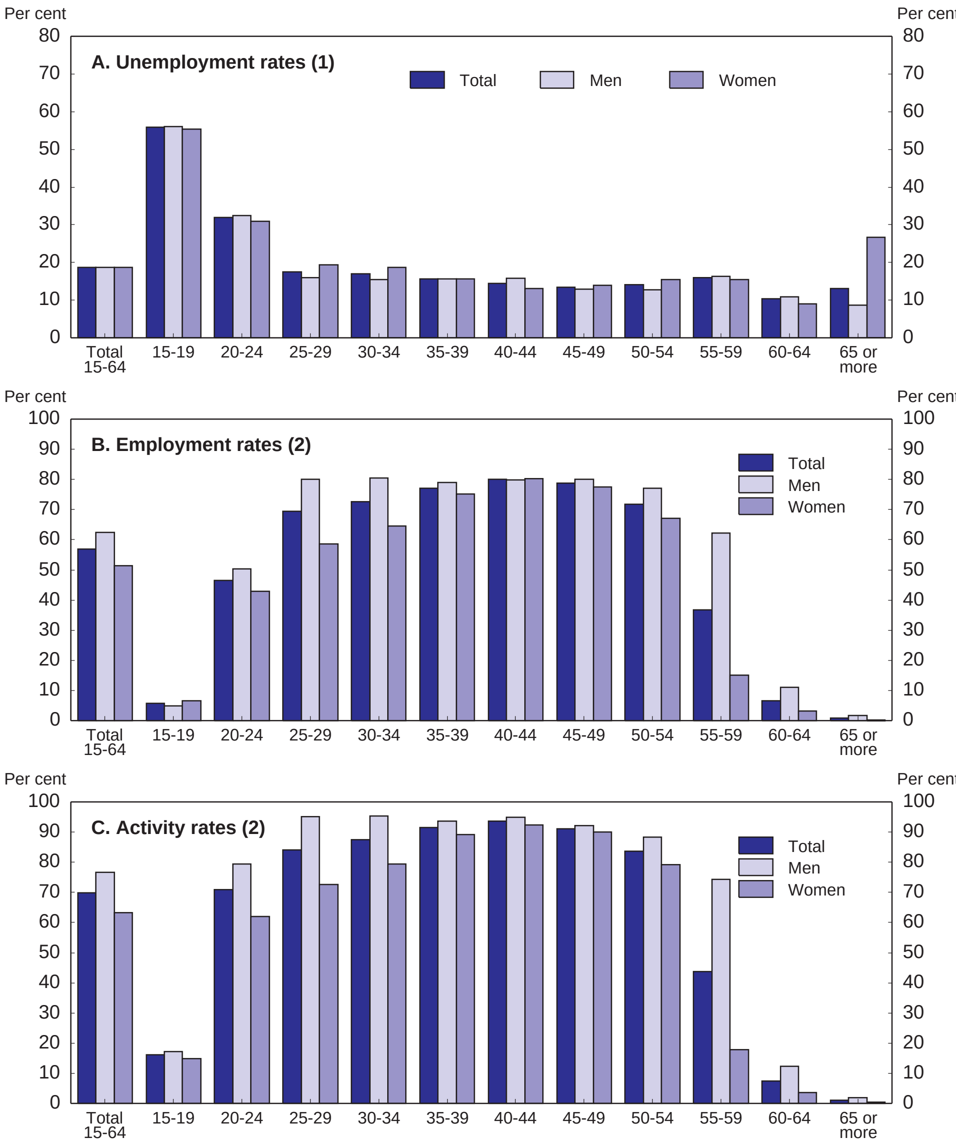
Labour market shortcomings[81]

Despite a decline of involuntary unemployment and gently rising employment since 2001, Slovakia continues to be among the weakest labour market performers in the OECD area (OECD *Employment Outlook*, 2003). While the activity rate remains above the average, the employment rate is among the lowest and the unemployment rate is the second highest in the OECD area (Figure 22). The exhaustion of labour reserves in high-growth regions and high-skilled occupations co-exists with massive unemployment in backward regions and among the low-skilled. According to the latest available international comparisons Slovakia has the highest unemployment rate for the low-skilled (39 per cent in 2001), one of the highest for young age workers (37 per cent), and the lowest employment rate of the population aged 55 to 64 (at 20 per cent). In addition to the high youth unemployment rate, the proportion of the 15-19 years old who are *neither* in education *nor* in the labour force is also the highest in OECD, at 25 per cent. Finally, excess employment in the public sector, notably in education, health, railways and energy utilities, is sizeable, and new entries into unemployment by low-skilled workers are expected from forthcoming rationalisation of public expenditure (see above Chapter III).

Indeed, the Slovak employment structure is characterised by an exceptionally high share of general government employment (Table 25). In comparison to other OECD post-transition economies (Czech Republic, Hungary and Poland), Slovakia's share of general government employment is one of the highest (21 per cent) and its share of self-employment the lowest (8.7 per cent). When compared to the wealthiest OECD countries the share of general government in total employment remain very high, below Scandinavian countries' exceptional rates gravitating around 30 per cent, but well above Germany's 11 per cent, Ireland's 12 per cent and United States' 15 per cent.[82] Over the last decade, public employment grew faster than private employment in only two OECD countries, Korea and Slovakia (OECD *Employment Outlook*, 2003).

Unemployment rates differ significantly with respect to educational achievement. For instance the proportion of the 25-to-64 year old males in unemployment ranges from 4.5 per cent for those with tertiary education to 44 per cent for those with less than upper secondary education. The incidence of long-term unemployment continued to rise over the last 5 years, reaching almost 60 per cent of total unemployment (Figure 23).

Figure 22. **Labour market indicators by age and gender**
2002



1. As per cent of the age group labour force.
2. As per cent of the age group population.

Source: Statistical Office of the Slovak Republic and OECD.

Table 25. **Dependent employment by sector**

	2002	
	Thousand persons	Per cent
Agriculture	131.4	6.2
Industry	640.9	30.1
Construction	176.0	8.3
Trade, hotels and restaurants	340.0	16.0
Transport, storage, post and telecommunication	154.4	7.3
Real estate, finance and business services	143.0	6.7
General government employees	454.0	21.3
Public administration[1]	149.7	7.0
Education	162.8	7.7
Health	141.5	6.7
Other	87.6	4.1
Total	2 127.0	100.0

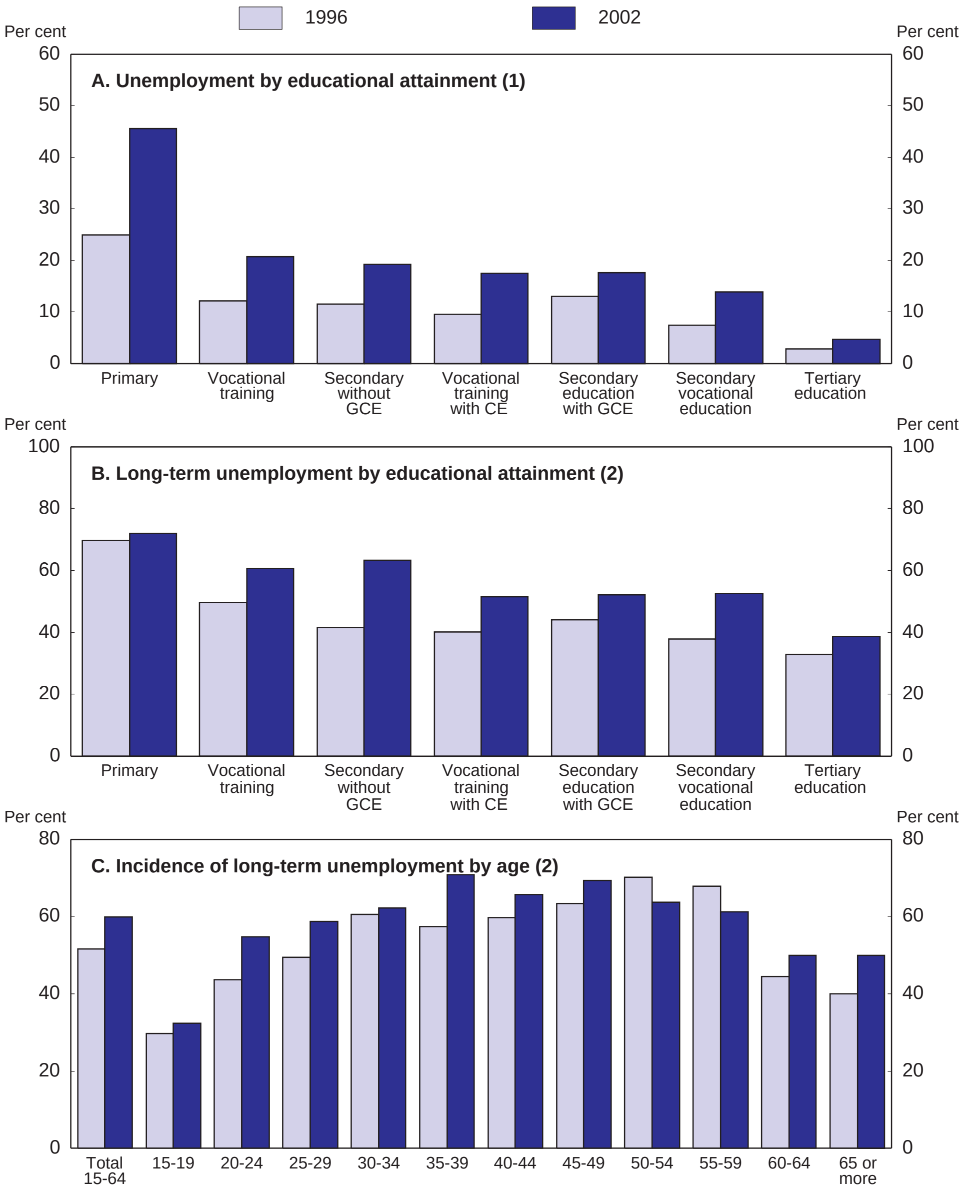
1. Public administration and defence; compulsory social security.
Source: Statistical Office of the Slovak Republic.

Against this background, the education and training system falls short of meeting the changing requirements of employers while an obsolete vocational training system continues to generate skills not demanded by the market (see Chapter III). Human capital upgrading for the long-term unemployed and the inactives is even more difficult to achieve. Efforts of the Public Employment Service (PES) to enhance the employability of job seekers through active labour market programmes have not been successful – due in all likelihood to inadequate schemes, ineffective organisation and limited resources. The number of retraining courses offered to the unemployed have increased but only one-fifth of the retrained have been able to find jobs. These retraining services should be adapted to market needs by funding providers on a competitive basis and according to "money follows the user" principles. The government will merge PES and welfare offices and might envisage experimenting with job-search services sub-contracted to commercial providers. European Social Fund (ESF) resources will be used in such innovative projects. Hence, the actual size of the PES budget in 2004 and the years beyond will depend on the country's ability to use ESF funds.

Labour supply issues

The authorities have attempted to raise work incentives by tightening access to welfare benefits, implementing a series of restrictive measures since 2001. In 2003, they further tightened up on access provisions (see below Box 14). Nevertheless, the share of benefit recipients in the working-age population

Figure 23. **The structure of unemployment**



1. As per cent of the labour force in the category.
2. As per cent of unemployed in the category.

Source: Statistical Office of the Slovak Republic and OECD.

remains high, especially in the category of disability benefit recipients (Table 26).[83] The procedures for reporting job-search efforts were also tightened in January 2003[84]. The official unemployment rate declined to 14.8 per cent by July and 13.75 per cent by October. The reduction may be partly due to exclusions from the register following the tightening of eligibility measures. However, there is evidence that the decline is to a significant extent driven by improvements in labour market conditions. For example, the survey (LFS) unemployment rate – conducted using ILO methodology – also declined, to 18.4 per cent in the first and 17 per cent in the third quarter of 2003.

To enhance the motivation of low-income earners to work, the authorities kept increasing the national minimum wage relative to the average wage from 35.6 per cent in early 2001 to 41.2 per cent in the last quarter of 2002 and to some 45 per cent in October 2003. Nevertheless, the share of workers earning the statutory minimum has remained low, reaching 1.2 per cent with a considerable regional variation.[85] This share is about twice as high in the public sector as in the business sector.

Labour mobility remains among the lowest in the OECD area. The majority of the population lives in owner-occupied dwellings, there are huge real estate price differentials between the prosperous and poor regions, and there is a severe shortage of affordable rental housing throughout the country.[86] The prices of regional bus and train services are high relative to wages so that commuting is largely limited to short distances. Researchers at the Ministry of Labour concluded that Slovak workers in high-unemployment districts are willing to pay up to 13 per cent of their take-home pay for transport, providing that daily commuting does not exceed 2 hours. However, willingness to commute declines rapidly with the

Table 26. **Benefit recipients by income support scheme**

	1998	1999	2000	2001	2002	2003[1]
	Per cent of working age population					
Unemployment insurance[2]	3.6	4.3	2.7	2.8	2.6	2.3
Disability	8.5	8.6	8.6	8.6	8.6	8.6
Full	6.8	6.7	6.6	6.6	6.5	6.5
Partial	1.8	1.9	1.9	2.0	2.1	2.1
Early retirement	0.7	0.8	0.6	0.1	0.0	0.0
Social assistance	5.1	7.1	8.5	8.8	8.5	8.2
Active labour market programme[3]	1.4	0.8	0.9	0.9	1.8	1.8
Total	19.4	21.6	21.3	21.2	21.6	21.0

1. Preliminary.
2. Registered unemployed only.
3. Participant inflows in public employment services, training, measures for youth and the disabled and subsidised employment.

Source: Ministry of Labour, Social Affairs and Family; National Labour Office.

duration of unemployment.[87] As in other OECD countries, the long-term unemployed probably become highly risk-averse, as they run out of resources to cope with unexpected expenses. Overall, the underlying problem appears to be the welfare system that nurtures unrealistic wage aspirations. Wage aspirations of the short-term (up to 6 months) and long-term (over 1 year) unemployed are practically identical. Unemployed school leavers without any prior job experience, a group with access to welfare benefits (at a reduced 50 per cent rate), also appear to have unrealistic wage aspirations. The authorities first addressed the problem of low mobility with subsidies to the transport costs of the registered unemployed who found jobs, but this programme was phased out in 2003.

Labour demand issues

The authorities have also been working to raise the demand for labour through a variety of measures. The amended labour code became effective in July 2003. It simplifies procedures for hiring, firing and re-assigning employees, increases the upper limit for overtime work and reduces the influence of trade unions on management decisions (Box 13). The experience of other OECD countries suggests that these reforms should contribute to employment growth. Nevertheless, some provisions of the amended code still appear to be excessively generous for a catching-up economy. For instance, the *statutory* right of all employees to at least 4 weeks of paid vacation increases significantly total labour costs. Another example is the requirement for employers to provide meal subsidies to all workers. Such matters should be determined by voluntary agreements between management and the workforce in individual firms rather than by fiat.

Slovakia's collective bargaining system has been changed so that it does not pose as a significant source of wage pressures any longer. The extension of sectoral wage bargains to firms that did not participate in the bargaining process has been made conditional upon written consent of the firm. However, there is a need to make this policy, which is now based on a discretionary decision by the minister, permanent through legislation.

The social-security reforms that are to be implemented next year should reduce the combined contributions (paid by employees and employers) by 3 percentage points of wages and should contribute to labour demand (Table 27). The contributions paid by employers will decline by 3.6 percentage points while those paid by employees will rise by 0.6 percentage points. More importantly, the overall tax wedge is set to decline significantly due to the combined effect of the tax and welfare reforms. Labour costs are going to be eased most substantially in the low end of the labour market where the cost-elasticity of labour demand is presumably highest. This is an important development, but the social-contributions rate of 47.8 per cent of gross wages is still among the highest in the OECD and should be reduced further.

Box 13. The Labour Code reform

Major amendments to the Labour Code were adopted in June 2003 and became effective as of 1 July 2003. The most important provisions are:

Labour contracts

Employers are able to choose among five types of labour contracts, depending on their requirements:

- Regular employment contract.
- Part-time employment contract for less than 40 hours per week.
- Part-time employment contract for less than 20 hours per week.
- Agreement on performance of work for less than 300 hours per year.
- Agreement on performance of work with a student for less than 100 hours per year.

All the above contracts can be concluded for a limited period of time and the employer is given the right to prolong them without being obliged to provide legal justification for doing so up to a maximum three year period. Some categories of employees are exempted from this maximum three year period which means limited period contracts can be prolonged in these cases indefinitely.

The overtime limits are increased so that an employee may work up to 400 overtime hours per year (previously the limit was 150 overtime hours). Within this total overtime limit, a maximum of 150 hours may be requested by the employer alone and a further 250 hours overtime is allowed if mutually agreed between the employer and the employee.

Termination of employment

More flexibility is introduced as regards an employer's right to terminate an employee's contract. When terminating an employment contract the employer is obliged to specify the reasons for termination. These are more extensive than previously allowed. For example, an employer will be entitled to terminate an employment contract for violations of work discipline or due to unsatisfactory work results. In such circumstances, prior written notice to the employee to improve work performance is required.

In all cases the statutory notice period is reduced to two months regardless of the reason for termination. An employee working for the same employer for more than five years shall be given three months notice, unless a more favorable notice period is agreed in the individual employment contract or a collective agreement.

When made redundant, an employee may either accept an agreement on early termination and receive a redundancy payment amounting to at least two-times his/her average monthly salary, or continue working during the notice period without the right to receive the redundancy payment, unless stipulated otherwise in a collective agreement. An employee working for the same employer for more than five years is entitled to receive a redundancy payment amounting to at least three-times the average monthly salary received by him/her during the notice period.

Box 13. **The Labour Code reform** (*cont.*)

An employment contract concluded for a definite period can be terminated prior to the agreed upon term without the employer providing a reason. However, the dismissed employee is entitled to receive compensation for future earnings.

Part-time employment contracts for less than 20 hours per week as well as certain types of special agreement on performance of work can be terminated, without the employer providing a reason, on 15 days notice.

Worker representation and other changes

The new law also brings other changes, including the possibility of both an employee's council and trade union organization existing within the same company, protection from discrimination, and the possibility to employ pensioners on more flexible terms.

Source: Dagmar Žukalová, KPMG Slovakia.

Table 27. **Contribution rates for social security programmes**
Per cent of wages

Paid by	2003			2004		
	Employee	Employer	Combined	Employee	Employer	Combined
Pensions	6.4	21.6	28.0	7.0	19.0	26.0
Old age				4.0	16.0	20.0
Disability				3.0	3.0	6.0
Guarantee fund				0	2.75	2.75
Provident fund				0.0	0.25	0.25
Sickness insurance	1.4	3.4	4.8	1.4	1.4	2.8
Unemployment insurance	1.0	3.0	4.0	1.0	1.0	2.0
Healthcare	4.0	10.0	14.0	4.0	10.0	14.0
Total	**12.8**	**38.0**	**50.8**	**13.4**	**34.4**	**47.8**

Source: OECD.

The government's new employment strategy

The government made public its blueprint of a new strategy for employment growth in May 2003 (Box 14). The strategy is based on further welfare and labour market reforms that would encourage job growth. If the intended overhaul of the social safety net and labour market institutions is implemented effectively, then the employment rate should increase despite the continued growth of the

Box 14. The new employment strategy

The draft of the government's new employment strategy was prepared by the Ministry of Labour, Social Affairs and Family. It emphasises the necessity for radical changes in welfare, child benefits, housing and labour markets to enhance the still weak employment growth. These changes aim to further improve work incentives and labour market flexibility. They entail a complete overhaul of the current social safety net and continued reforms of the labour code.Most elements of the strategy have been turned into concrete legislation and a gradual implementation of the employment strategy is scheduled to start in January 2004, together with reforms of the pension and tax systems. The following information on the key policy measures is based on the draft strategy document and recent statements by the authorities.[1]

The current welfare system is inequitable in the sense that it provides social assistance to some 12 per cent of the total population without adequate checks. Thus a widespread abuse of the system has been a common practice. To increase employment and improve employability, the strategy proposes to replace dysfunctional welfare with a system that rewards work. A thorough overhaul is also planned for the system of child benefits to reward working parents with significantly higher transfers.

To motivate welfare recipients to work, the welfare benefit for a single adult will be unified at SKK 1 450 (about € 35), an amount below the so-called "life minimum" which represents the threshold below which a person is considered to be in "material need".[2] The maximum welfare benefit for a family with more than 4 children will be cut by 60 per cent to SKK 4 210 (€ 105) per month. Welfare recipients will be also eligible for a monthly housing benefit amounting to SKK 780 for singles and SKK 1 330 for families. The combined (welfare and housing) monthly benefit will thus range from SKK 2 230 (€ 56) for singles to SKK 5 540 (€ 139) for large families.

To strengthen work incentives further, additional benefits will be available to families living on earned income, or demonstrating a willingness to work by participating in active labour market programmes. Part of child benefits will be granted in the form of tax bonuses.[3] The combined welfare and housing benefit will also be paid to successful job-seekers during the first 6 months of gainful employment, boosting their earned income.

To promote labour market flexibility, the strategy aims to create conditions for non-traditional forms of work, to subsidise transport of commuters and to revive the construction of low-rent housing that dropped to extremely low levels during Slovakia's transition to a market economy. The legislation will also define for the first time the regulations governing temporary work agencies that have operated on a small scale and under legal uncertainty to date. The Act on Public Employment Services covering policies will be effective as of February 2004.

On the basis of new financing from the European Social Fund,[4] the strategy also plans to offer employment subsidies to firms hiring long-term unemployed. The rate of these subsidies will vary according to the type of workers hired and the

Box 14. **The new employment strategy** (*cont.*)

region, and may attain 25-35 per cent of total labour costs in the most disadvantaged areas. These subsidies will be paid during two years following the hiring. The government recently decided to accelerate the phasing-in of this measure and to make it available in the first half of 2004.

1. See Ministry of Labour, Social Affairs and Family (2003).
2. Currently, the housing benefit can be claimed by any household provided that it either rents or owns a dwelling and that the so-called minimum housing cost exceeds 29 per cent of its income; the minimum cost is specified by law and increases with the number of members of the household up to 4 persons.
3. Child benefits will be available to families with children who attend school regularly, regardless of income. The basic benefit will be SKK 500 per child per month. A supplementary monthly benefit of SKK 400 per child will be provided in the form of either tax relief or tax refund to gainfully employed parents only. It is probable that this will reduce truancy in elementary and secondary schools as well as encourage formal employment of parents.
4. The contributions expected from the ESF play a central role in the budgeting of the new labour market programmes. The Ministry of Labour anticipates that these contributions will double its budget in 2004. Notably, € 300 million are expected in January 2004 to phase-in the employment subsidy programme for the long-term unemployed.

working-age population that is likely to persist until the end of this decade. For the first time since the introduction of welfare in 1990, it would pay for the low-skilled unemployed to work in the legal economy rather than remaining dependent on welfare, while employers' hiring incentives would strengthen due to lower labour costs and the availability of contracting through temporary work agencies. The experience in some OECD countries shows that temporary work expands job opportunities and leads frequently to regular employment. It therefore seems to be particularly promising for low-employment economies in transition.

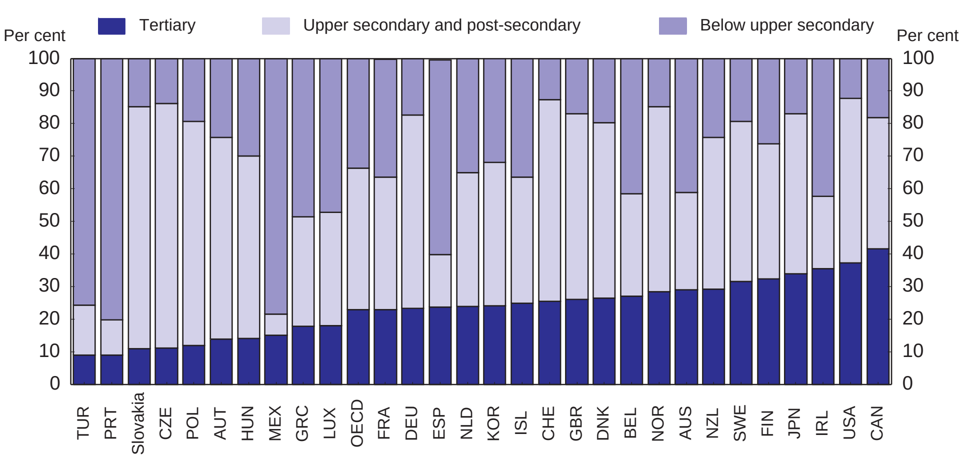
Another employment-enhancing initiative by the government is to gradually increase the retirement age to 62 years for both men and women. Plans adopted in 2002 first aimed at unifying the retirement age at 60 (previously 60 years for men and 53-57 years for women, depending on the number of children) but the new government got parliamentary support for a further extension to 62, following difficult political negotiations. The new retirement age is still lower than in OECD countries, but it represents major progress in the Slovak context. Lower – and only gradually improving – life expectancy is a relevant consideration in the determination of the retirement age (see the section below on providing sustainable retirement income).

There are some apparent shortcomings in the government's approach to employment and welfare. The intended welfare reform does not address specifically the problems facing the most disadvantaged group – the Roma living in segregated settlements (see also Box 15 on Roma unemployment). The increased pauperisation of this disadvantaged minority is a serious risk and the authorities might want to consider targeted measures to prevent this from happening. Nevertheless, the radical reorientation of welfare towards "workfare" does address a fundamental problem in Slovakia, and perhaps only such shock measures can rapidly achieve the cultural shift required to achieve high employment in the medium-term.

Enhancing human capital

Slovakia offers, in broad terms, an attractive combination of labour force quality and wage levels. However, lack of labour-market relevant education and training opportunities remains a serious problem. According to a survey of Slovak business managers (BAS 2002), the public education system's emphasis on passive learning results in poor managerial and language skills of the school leavers as well as their inability to cope with real-life situations in the workplace. Moreover, vocational training programmes still produce graduates with obsolete skills while not responding to emerging labour-market bottlenecks. The level of public spending on education is among the lowest in the OECD area while long-duration university programmes with restricted access contribute to a comparatively low proportion of post-secondary graduates in the Slovak population (Figure 24).[88] According

Figure 24. **Educational attainment**[1]
2001



1. Distribution of the population aged 25 to 64, by level of educational attainment. For Austria data in 2000.
Source: OECD (2003b).

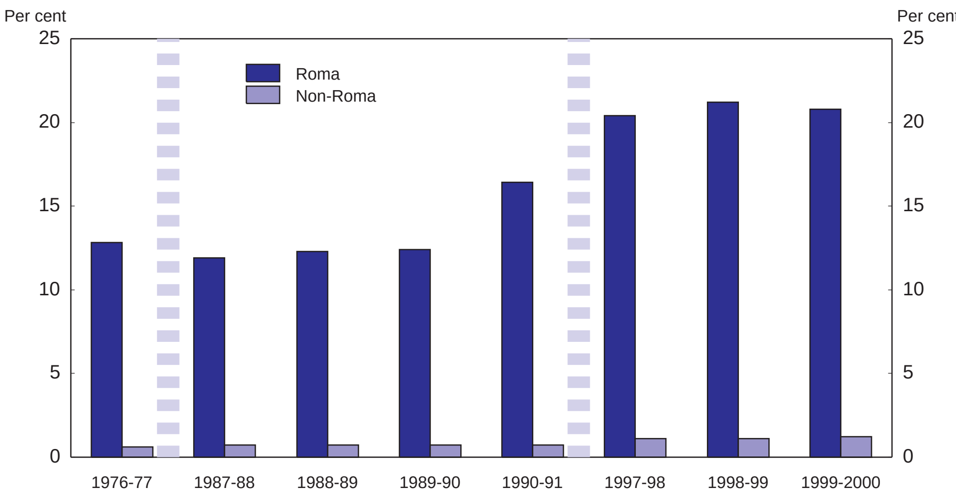
to the Ministry of Education only 41 per cent of this year's high school graduates will be accepted to University, while the objective is to rapidly raise this proportion to above 50 per cent.

The new Law on Universities, adopted in 2002, transforms tertiary institutions into non-governmental organisations, makes tuition fees for "external" (part-time) students applicable (an earlier decision to that effect had been suspended following protests) and authorises the creation of new private universities. Ten to twenty per cent of university budgets will from now on be funded by tuition fees and these are only the initial steps of reform. No tuition fee is yet applicable to ordinary students, against strong evidence that returns on tertiary education are largely private so that costs should plausibly be born by those receiving it. No student loan system is yet in force to make tuition fees acceptable to low income groups. However, new legislation is being finalised, which introduces tuition fees of 5-30 per cent of average per-student costs, constitutes income-contingent loans (ICLs) as a potential universal means of finance for students, involves redirection of state subsidies to subject areas with high social returns and also redirects support for housing from the suppliers (*i.e.* residence halls) to customers (*i.e.* students), who will be given a studentship based on social need. The aim is to promote access to higher quality tertiary education and boost the tertiary education budget via fresh inflows of private funding, i.e. without incurring an immediate extra burden on public finances and with low public finance costs in the long-run. The new system is planned to be launched as of the new academic year in 2004. The opening of new universities still remains subject to the approval of academic committees dominated by tenured university professors who are reluctant to encourage competition. The authorities should consider further measures to stimulate the development of private universities.

In the business sector, foreign-invested firms hire university graduates in large numbers, even for relatively low-skilled positions. This seems to indicate that the quality of Slovakia's secondary education is not adequate.[89] The need for thorough reform in the secondary education system – both in general and vocational streams – has already been fully recognised (see Chapter III) but no major initiative has yet been launched by the new government other than through decentralising secondary education institutions to regional governments. The consequences of decentralisation on the quality of secondary education remain still unknown. Widening room for competition may be one benefit of decentralisation. Legally, room is open for private establishments at regional level, but effective competition between existing and new schools will depend on regional governments' policies, notably concerning the allocation and rental prices of school buildings, and whether or not voucher systems will be introduced.

Revitalizing the human capital of the long-term unemployed is the most complex challenge for the training system and employment services. Nearly

Figure 25. **Roma *vs.* non-Roma educational performance**
Failing pupils as a percentage of total pupils in the group



Source: Statistical Office of the Slovak Republic.

90 per cent of the long-term jobless have only primary or vocational education or less, and skills often so irrelevant that the majority of them are considered functionally illiterate. The Ministry of Labour estimates that 170 000 persons, close to half of all the unemployed, cannot find jobs with their present human capital. The fact that a large part of the long-term unemployed are of Roma origin and received a lower quality primary education in the first place,[90] complicates the problem. This fringe of the population has an unsatisfactory reputation in workplaces, suffers prejudices, and lacks the trust of customers in service activities. The educational performance of Roma pupils has not improved (Figure 25). Modern Slovakia is trying to address this problem outside ethnical and cultural realms (without assigning any special status to this minority in the development of policies), but the magnitude and resilience of the human capital and employment challenges probably call for an ad hoc, special approach (Box 15).

Sustainable development issues

There is growing concern that long-run sustainable development may be compromised unless measures are taken to achieve balance between economic, environmental and social outcomes. This section looks at three specific issues of sustainable development that are of particular importance for the Slovak Republic:

Box 15. The Roma problem

As the principal losers of post-communist transition, the Roma became more dependent on welfare benefits than any other group in Slovakia.[1] The exact size of this visible minority is unknown.[2] Researchers based at the Slovak Statistical Bureau estimate that there are some 385 000 Roma who account for 7 per cent of the Slovak population. The comparative demographic dynamics implies that this proportion is likely to increase to 10 per cent in 2025 and peak at 11 per cent in 2035 (Vao, 2002).[3] According to a government report, some 128 000 Roma live in segregated settlements that typically lack access to standard utilities (electricity, heat, telephone lines, water and sewage).[4] This isolated population appears to have grown rapidly over the 1990s as cheap rental housing became extremely scarce and the construction of social flats ground to a standstill. The settlement communities typically have no property rights with respect to the land on which they live.

Government data indicate that some 60 000 working-age persons live in these settlements, about 90 per cent of whom are believed to be unemployed, most of them long term. Assuming that the remaining (integrated) Roma population is characterised by unemployment rates consistent with their low educational achievement, the ethnic minority accounts for 25 per cent of all unemployed, 36 per cent of the persons unemployed over 1 year and above 50 per cent of those unemployed longer than 2 years. These calculations are consistent with the involuntary unemployment rate of 83 per cent for the Roma population that is implied by recent labour force surveys.[5]

What can be done to activate the working-age members of this ethnic minority who have become almost entirely dependent on welfare benefits? Given the different characteristics of the Roma living in segregated settlements and those who share the lifestyle of low-income, non-ethnic households, specific policies may well be called for. The more integrated Roma would benefit from the same programmes as the other unemployed with low educational attainment that are endorsed in this chapter. Given the increasingly negative perception of the Roma by the mainstream population, some affirmative measures in the education system and the workplace should help to improve their employment prospects.[6]

The measures necessary to activate the population isolated in settlements are less obvious. Recent initiatives, co-financed by EU Phare funds, aim at improving infrastructures and social work in these settlements but it is too early to assess the results.[7] The welfare benefit cuts now being enacted are unlikely to push many of the working-age Roma living in settlements into legal employment, given the absence of suitable jobs for them, and difficulties in finding affordable transportation. The rational response to benefit cuts, pursued typically by the best educated and most dynamic Roma, is to leave Slovakia and find relatively attractive employment in the neighbouring Czech Republic or to enter labour markets in the West via the refugee channel or illegal work.[8] Adverse selection combined with overwhelming welfare dependence, poor health status and inferior education, implies that the settlement population remaining in Slovakia is unlikely to see its living standards improve in the foreseeable future. In the short

Box 15. **The Roma problem** (*cont.*)

term, only marginal improvements can be expected from a few projects financed by the EU and the World Bank. Ongoing education and de-centralisation reforms could have deeper impacts, such as the intended school mergers which should promote multi-ethnicity in the school system, if bussing services can be put in place to widen the catching areas of the schools. Regional and municipal governments' policies concerning multi-ethnicity in the school system will also have an impact.

1. For a comprehensive description of the socio-economic situation of Slovak Roma see Vaeka and Radiová (2002).
2. The current anti-discrimination legislation discourages the Statistical Bureau and other government agencies from collecting data based on ethnicity.
3. Other estimates put the share of Roma population at 8-10 per cent. See *e.g.* World Bank (2001).
4. See Government of the Slovak Republic (2002).
5. Unpublished parts of these surveys indicate that the unemployment rate of the Roma increased from 78 per cent in 1997 to 83 per cent in 2002.
6. For instance, local authorities could reserve a specific percentage of low-skilled jobs for Roma school janitors, canteen employees, and so on.
7. An Office for Roma Minority Issues is also created in the Deputy-Prime Minister's Office and will be further expanded. The Ministry of Labour and Social Affairs created a Social Development Fund with a budget of SKK 200 million over two years, to form partnerships aiming to foster the social inclusion of disadvantaged groups.
8. Press articles suggest that this exodus of the most dynamic part of the Roman population living in settlements has indeed taken place. While employment commensurable with their skills is relatively easy to find in the Czech Republic, given the presence of relatives and aversion of Czech welfare recipients to low-wage jobs, the refugee channel has been blocked by restrictive measures of recipient countries, especially in Western Europe.

climate change, air pollution and sustainable retirement incomes. In each case, indicators are presented to measure progress and the evolution of potential problems, and an assessment is made of government policies pertaining to the issue. The section also considers whether institutional arrangements are in place to integrate policy-making across the different elements of sustainable development (see Box 16).

Climate change

Main issues

Although its greenhouse gas (GHG) emissions are set to be well below the Kyoto target in 2008-12, the Slovak Republic has a very high emission intensity compared with most Member countries. To reduce GHG emissions in the medium

Box 16. The integration of policies across sustainable development areas[1]

The integration of policies across the different sustainable development areas has been strengthened over the past 10 years. The importance of the economic/environmental interface was recognised in the 1993 Strategy of National Environmental Policy and the 1999 Environmental Action Programme, and the medium-term economic strategy of the country mentions the goals set in the environmental programme. Approved by the government and the parliament in 2001, the National Strategy for Sustainable Development asks all relevant ministries (including the economic and social affairs ministries) to incorporate the principles and goals of sustainable development into their sectoral policies, plans and programmes. The Council of the Government for Sustainable Development, headed by a Deputy Prime Minister, was established in 1999 to give advice on all important government strategies, plans and programmes from the point of view of sustainable development principles.

Environmental impact assessments (EIA) have been used in the Slovak Republic. A 1994 law made such assessments obligatory for projects in certain specified activities, such as road and highway constructions, waste disposal and wastewater treatment. The range of activities that must be subject to EIA was expanded in 2000. As a result of such assessments, projects have sometimes had to be amended or abandoned as the environmental damage was judged to be excessive. Strategic environmental assessments (SEA) are also required by law to evaluate national policies and programmes concerning sectoral policies. For example, SEA has been used for the development of energy policies. However, such assessments are not always carried out in the areas where the law calls for them (*e.g.* transportation). The authorities have not used cost-benefit analysis as a regular policy integration tool in the past. Such analysis is not required for either policy programmes or projects, and has only been applied to projects funded by the European Union.

1. The sections in this report dealing with climate change, air pollution and retirement income policies are inputs into the Organisation's follow up on Sustainable Development as mandated by the Ministerial Council decision in May 2001.

and long term, the authorities have established a climate change strategy, which is also linked to efforts to reduce distorted resource allocation inherited from central planning. The main issues in this regard are how to ensure that the most cost efficient means are used for abatement and that the social safety net in place can deal with any adverse social consequences.

Performance

In 2000, GHG emissions were 24 per cent below the 2008-2012 target in the Kyoto protocol which was set for Slovakia at minus 8 per cent of the 1990 level.

With unchanged policies, official projections suggest that emissions are most likely to stay below target, even if activity expands at a fast rate. However, and despite the fact that GHG intensity fell comparatively strongly in the 1990s, emissions per unit of GDP are still higher than in most Member countries (Tables 28 and 29). The bulk of the reduction in the economy-wide emission intensity was due to the manufacturing sector, where industrial restructuring resulted in a striking

Table 28. **Main indicators: climate change**

Indicators of greenhouse gas (GHG) emission intensity, grams of CO_2 equivalent per $PPP of GDP, in 1995 prices

	Total GHG emissions	CO_2 emissions, electricity	CO_2 emissions, transport	Other GHG emissions	Total GHG emissions	CO_2 emissions, electricity	CO_2 emissions, transport	Other GHG emissions
	Level, 2000				Average annual percentage change 1990-2000			
Australia	1 061	360	159	542	–1.82	–0.46	–1.52	–2.70
Austria	403	66	96	241	–2.05	–3.20	–0.02	–2.42
Belgium	600	105	97	398	–1.47	–1.27	–0.19	–1.81
Canada	888	156	183	549	–0.94	0.24	–0.85	–1.28
Czech Republic	1 082	468	100	514	–2.77	2.54	6.33	–6.58
Denmark	501	171	88	242	–2.38	–2.73	–0.84	–2.64
Finland	597	178	99	321	–2.56	–0.17	–1.83	–3.84
France	402	30	102	271	–2.00	–2.60	–0.02	–2.57
Germany	519	168	91	260	–3.92	–3.57	–1.05	–4.95
Greece	819	275	122	422	–0.16	0.07	–0.02	–0.34
Hungary	747	192	79	476	–2.60	–1.30	–0.24	–3.40
Iceland	398	0	84	314	–1.82	. .	–2.47	. .
Ireland	643	152	98	392	–4.63	–2.97	0.23	–6.03
Italy	432	108	89	235	–1.06	–0.43	0.01	–1.70
Japan	441	132	81	229	–0.34	0.13	0.89	–0.99
Luxembourg	314	6	249	59	–12.47	–27.09	0.62	–23.13
Netherlands	553	138	80	335	–2.49	–0.95	–1.09	–3.34
New Zealand	1 078	82	179	817	–2.21	2.87	0.80	–3.12
Norway	454	3	97	354	–2.91	–1.57	–2.86	–2.93
Poland	1 109	458	74	576	–7.12	–6.48	–1.39	–8.08
Portugal	516	129	111	276	–0.06	0.85	3.47	–1.51
Slovakia	**846**	**249**	**70**	**526**	**–5.21**	**0.98**	**1.98**	**–7.60**
Spain	536	130	127	278	0.35	1.21	0.97	–0.28
Sweden	340	35	110	195	–1.91	–1.52	–0.77	–2.56
Switzerland	267	2	78	187	–0.94	–3.82	–0.40	–1.11
United Kingdom	512	137	106	268	–3.58	–4.30	–1.41	–3.94
United States	779	273	192	315	–1.86	–0.73	–1.30	–3.04
OECD total	639	201	137	307	–1.88	–0.79	–0.58	–2.90
EU	491	120	100	272	–2.43	–2.36	–0.40	–3.10

Source: Greenhouse gas emissions: national submissions to the UNFCCC and national publications. Carbon dioxide emissions for electricity and transport: IEA (2001). GDP: OECD, SNA database.

Table 29. **GHG emissions and sectoral indicators**

	Total GHG emissions		CO_2 emissions per Kwh electricity	Manufacturing CO_2 emissions per unit of output	Residential CO_2 emissions per unit of private consumption	Road transport CO_2 emissions per vehicle-kilometre	Electricity use per unit of GDP	Manufacturing output per unit of GDP
	Level million tonnes CO_2 equivalent 2000	Annual average percentage change						
		1990-2000	1990-2000	1990- 2000[1]	1990- 2000[2]	1990- 1999	1990- 2000	1990-2000[1]
Australia	502	1.7	0.1	–0.7	–1.1	–0.8	–0.6	–1.6
Austria	80	0.3	–3.3	–1.7	–2.4	–1.8	0.1	0.3
Belgium	152	0.7	–1.1	–0.2	–1.1	–0.8	–0.2	–0.5
Canada	726	1.8	0.7	–2.6	–2.0	–0.4	–0.5	1.0
Czech Republic	147	–2.7	–0.2	–7.7	–15.4	4.1	2.8	0.2
Denmark	69	–0.1	–3.4	–1.7	–4.0	–0.2	0.7	–0.6
Finland	74	–0.4	–0.9	–7.2	–7.0	–1.4	0.7	3.2
France	550	–0.2	–3.2	–2.4	–1.7	–0.5	0.6	0.3
Germany	991	–2.1	–1.5	–1.1	–4.0	0.7	–2.1	–1.8
Greece	130	2.2	–2.0	–0.4	2.6	–4.4	2.1	–1.7
Hungary	84	–1.8	–1.5	–12.7	–5.4	–3.3	0.2	5.3
Iceland	3	0.7	–4.9	. .	–7.7	0.3	2.6	. .
Ireland	67	2.2	–1.1	. .	–6.2	4.8	–1.8	. .
Italy	547	0.5	–1.2	–2.0	–1.4	–1.1	0.8	–0.2
Japan	1 386	1.1	–0.9	–0.8	0.1	0.3	1.0	–0.2
Luxembourg	6	–7.8	–24.6	–13.0	–2.3	3.8	–3.4	–2.2
Netherlands	218	0.4	–2.7	–1.8	–2.9	–0.1	1.8	–0.6
New Zealand	77	0.5	3.7	. .	–3.2	–2.1	–0.8	. .
Norway	55	0.6	0.5	0.8	–8.8	0.5	–1.9	–2.7
Poland	386	–3.7	0.5	–5.8	–6.7	–6.4	–6.9	4.4
Portugal	85	2.7	–0.9	0.7	–1.0	–0.4	1.8	–0.6
Slovakia	**49**	**–4.0**	**0.8**	**–4.7**	**–7.4**	**2.3**	**0.2**	**2.4**
Spain	386	3.0	0.0	–0.6	0.4	–0.3	1.2	–0.1
Sweden	69	–0.2	1.0	–4.7	–4.1	–1.4	–0.5	2.5
Switzerland	53	–0.1	–4.7	. .	–1.7	–0.3	1.1	. .
United Kingdom	649	–1.3	–3.6	–2.1	–1.9	–0.5	–0.7	–1.6
United States	7 001	1.3	–0.3	–4.0	–1.9	–0.2	–0.4	0.4
Total of above								
OECD countries	14 543	0.6	–0.8	–2.2	–1.8	–0.3	–0.2	0.0
OECD exc. US	7 542	–0.1	–1.2	–1.5	–1.7	–0.4	0.0	–0.3
EU countries	4 073	–0.3	–2.0	–1.8	–2.4	–0.4	–0.2	–0.7

1. 1991-2000 for Germany and Hungary; 1992-2000 for Poland; 1993-2000 for Slovakia; 1990-1999 for Portugal; no data for Iceland, Ireland, New Zealand and Switzerland.
2. 1991-2000 for Czech Republic; 1993-2000 for Slovakia.

Source: GHG National submissions to UNFCCC, national sources and UNFCCC; carbon dioxide data, IEA; manufacturing output, private consumption, OECD.

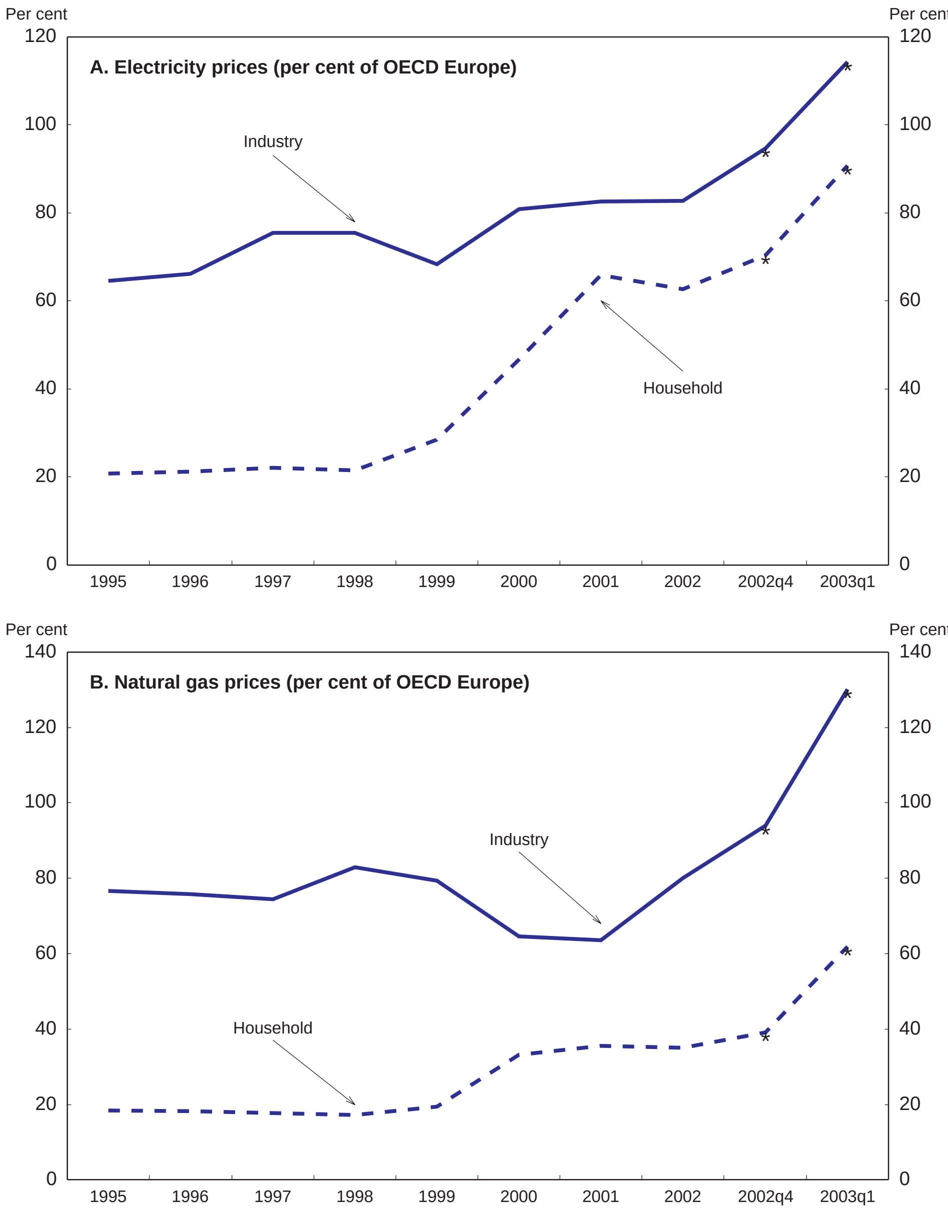
drop in the sector's emission-output ratio. In other sectors decoupling of emission from activity trends has been weak or even negative. Thus, carbon-dioxide emissions per KWh in electricity generation have fallen only modestly in comparison with developments in the EU area, with the high levels by international comparison reflecting the use of domestically-mined brown coal in production. Also, the cut in residential carbon-dioxide emissions per unit of private consumption was only in line with that in the EU area in spite of very different starting points, and the poor insulation of the housing stock continues to keep the emission intensity at the highest level in the OECD area. And emissions of GHG per vehicle-kilometre have risen substantially in contrast to the decline observed in most Member countries.

Policy

The 2001 Climate Change Strategy aims at ensuring an additional 5 per cent reduction relative to the 2008-2012 Kyoto Protocol target and preparing for a stabilisation of emissions after 2015.[91] The Strategy focuses on energy savings and reductions in emission intensities in power generation, but it also includes abatement efforts in other sectors. To reduce the economic costs of cutting GHG emissions, an emphasis is placed on providing economic incentives for abatement and allowing emitters or consumers the discretion to respond in the way that is most appropriate. The main constraints on implementing the Strategy are concerns about its social consequences, most notably the impact on poverty and the regional settlement pattern.

The authorities' policy of continuing the process of aligning energy prices with costs is likely to be the most cost effective way to reduce GHG emissions. As in other countries in transition, the root cause of the high energy intensity in the Slovak economy is slow progress in raising artificially depressed energy prices. Towards the end of the 1990s, the authorities raised energy prices substantially, almost doubling electricity and gas prices in real terms to all users between 1999 and 2000 but still leaving prices well below costs (see Chapter III) and much lower than the average for European Member countries (Figure 26). In 2000, the authorities planned to align energy prices for different users to costs over the following two years. In January 2003, energy prices had risen from their level of early 2000 by more than a third for industry and more than seventy per cent for households but remain noticeably lower than in Western Europe for households. The price hikes that have taken place in recent years will serve to lower energy and GHG emission intensities in the years to come and at the same time release resources in the energy sectors to be employed more productively elsewhere, thus benefiting the economy. A continuation of this process will allow GHG emission abatement at no cost to the economy. Several other measures currently employed to improve energy efficiency, notably energy audits and state subsidies, are unlikely to be cost efficient.

Figure 26. **Energy prices**



Source: International Energy Agency.

A trading system for carbon emission permits is planned and should provide a cost efficient way to reduce emission intensities in power generation and other large emitters. The Slovak Republic has initially prepared a domestic trading scheme that could start operating in 2005. As a result of the recent EU decisions on the enlargement calendar and on carbon trading, the Slovak cap-and-trade regime is bound to become part of the EU emission trading scheme. The emission price is likely to speed up the shift in fuel mix in electricity generation from relatively dirty brown coal to cleaner natural gas that has been triggered by recent cuts in coal subsidies. The government indeed decided in 2001 to put a cap on the share of coal in electricity generation: 10 per cent by 2005 falling to 6 per cent after 2010. In view of the accession to the European Union, greater emphasis is being placed on expanding renewable energy sources, notably biomass energy, as a means to reduce GHG emissions. They benefit from investment subsidies at present, and guaranteed favourable prices for producers are likely to be introduced in the near future. The experience of most European countries suggests that this would entail very high abatement costs.

The measures to reduce GHG emissions are likely to involve some adjustment costs for the social pillar of sustainable development. Though the associated improvement in economic efficiency should raise real incomes in the longer term, continued increases in energy prices will reduce the purchasing power of wages in the short term. However, authorities may decide to guarantee that energy price rises do not involve any hardship for the low-income segment by introducing targeted subsidies or lifeline services. As for the impact of carbon emission permit trading on the regional settlement pattern, it will inevitably add to economic problems in the brown-coal mining areas around Modry Karnen and Handlova. However, the scarcity rent associated with emission trading could be used during a transitional period to establish an alternative economic base for these areas.

Conclusions

Although the Kyoto target is set to be comfortably attained, the authorities have appropriately established a climate strategy to encourage emission abatement and increase economic efficiency. To reduce the still very high energy intensity of the economy, the process of raising energy prices to ensure at least cost recovery should be continued as this represents an opportunity to reduce emissions and strengthen the economy at the same time. Domestic and international emission trading will provide a targeted and cost-effective tool to reduce greenhouse gas emissions, and the prices established on the international market should serve as a ceiling for acceptable abatement costs in domestic programmes. The implementation of cost-efficient abatement measures will involve short-term adjustment costs. If the maintenance of the current regional settlement pattern is considered to be an important policy goal, it must be pursued with means that impose lower costs on the economic and environmental pillars of sustainable development.

Air pollution[92]

Main issues

Air pollution is a threat to health and quality of life, and damages ecosystems and structures. The economic costs, which are often indirect and can appear with a long lag, are estimated to be substantial in highly polluted environments.[93] The air quality in the Slovak Republic was in a very serious state at the start of the transition to a market economy in the early 1990s, but significant improvements have taken place since then. With the authorities targeting further reductions of emissions in order to improve ambient air quality, the challenge is to use instruments that impose the least cost on the economic pillar of sustainable development.

Performance

Despite the very significant reductions in emissions of traditional air pollutants relative to GDP in the 1990s, which largely resulted from the restructuring of the industrial sector in the period, the economy-wide emission intensity is still relatively high (Table 30). Sulphur dioxide emissions per unit of GDP fell by 80 per cent in the course of the 1990s, but their level at the end of the decade was more than three times that of the EU average and the fifth highest in the OECD area. This high level of emissions per unit of GDP is principally due to the still intensive use of sulphur-rich brown coal in electricity generation, as the shift from coal to natural gas and the deployment of desulphurisation technology remain quite limited. The fall in nitrogen dioxide emissions relative to GDP during the 1990s was less striking, as reduction in the emission intensity from stationary sources was partly offset by sharp increases in traffic-related emissions, and the emission-GDP ratio was around twice that in the EU area on average. The discharges of volatile organic compounds per unit of GDP have fallen at a similar rate as in the European Union, and the emission intensities were similar in both areas. The combination of falling domestic emissions and declining cross-border imports of pollutants has led to a halving of regional sulphur dioxide concentrations since the early 1990s but they still exceed critical loads in some areas. Sulphur depositions exceeding critical loads affect around 25 per cent of the territory.

Policy

Quantitative targets for emissions of air pollutants are established in domestic legislation and in international agreements. The authorities have set annual ceilings on sulphur-dioxide emissions over the 2004 to 2010 period with the

Table 30. **Main indicators: air pollution**

	Change in emissions per unit of GDP, 1990-99[1]			Level of emissions, 1999[2]		
	Sulphur dioxide	Nitrogen dioxide	VOCs	Sulphur dioxide	Nitrogen dioxide	VOCs
	Per cent per year			Grams per dollar of GDP		
Australia	3.1	–1.9	–2.9	3.9	5.5	4.1
Austria	–10.2	–3.5	–6.5	0.2	0.9	1.2
Belgium	–9.2	–3.6	–4.8	0.8	1.2	1.1
Canada	–5.3	–2.8	–2.9	3.2	2.6	3.5
Czech Republic	–19.1	–6.6	–5.7	2.1	3.0	1.9
Denmark	–14.2	–4.9	–5.2	0.4	1.6	1.0
Finland	–13.0	–3.8	–4.1	0.7	2.1	1.4
France	–8.3	–3.8	–5.1	0.5	1.2	1.4
Germany	–20.1	–7.1	–8.8	0.4	0.9	0.9
Greece	–1.4	–0.3	–0.2	3.6	2.5	2.6
Hungary	–6.1	–1.1	–3.8	5.5	2.1	1.4
Iceland	–1.1	–1.7	–4.9	3.7	3.9	1.4
Ireland	–8.1	–6.3	–7.9	1.7	1.3	1.0
Italy	–7.6	–4.3	–4.4	0.8	1.2	1.4
Japan	–1.7	–1.3	–2.4	0.3	0.5	0.6
Korea	–8.9	–3.3	–9.7	1.6	1.9	0.2
Luxembourg	–18.7	–9.1	–7.9	0.2	0.9	0.9
Mexico	–0.4	–0.9	–9.3	1.6	1.6	1.4
Netherlands	–10.1	–6.5	–8.8	0.3	1.1	0.7
New Zealand	–0.4	–0.5	–1.6	0.7	3.0	2.6
Norway	–9.7	–2.8	–1.8	0.2	2.0	3.0
Poland	–10.0	–6.6	–4.8	5.1	2.8	2.2
Portugal	–2.1	–0.9	0.1	2.4	2.3	3.1
Slovakia	**–13.7**	**–7.4**	**–5.6**	**3.3**	**2.4**	**2.0**
Spain	–5.8	–2.1	–3.5	2.2	1.7	3.6
Sweden	–8.3	–4.3	–3.9	0.3	1.3	2.1
Switzerland	–6.0	–5.4	–6.3	0.1	0.5	0.9
Turkey	3.2	1.0	0.0	3.4	2.3	1.6
United Kingdom	–13.9	–7.9	–6.6	1.0	1.3	1.4
United States	–5.5	–2.5	–4.7	2.0	2.7	1.9
European Union	–11.1	–5.0	–5.3	0.8	1.2	1.5
OECD Europe	–10.1	–4.8	–5.0	1.2	1.4	1.5
OECD	–6.7	–2.9	–4.4	1.5	1.9	1.6

Note: For the OECD average data for countries with missing data for either 1990 or 1999, data for the latest year has been substituted. Estimated data for 1999 represents about 5 per cent of the area total. GDP is measured in 1995 prices. Cross-country aggregations use 1995 purchasing power parity exchange rates.

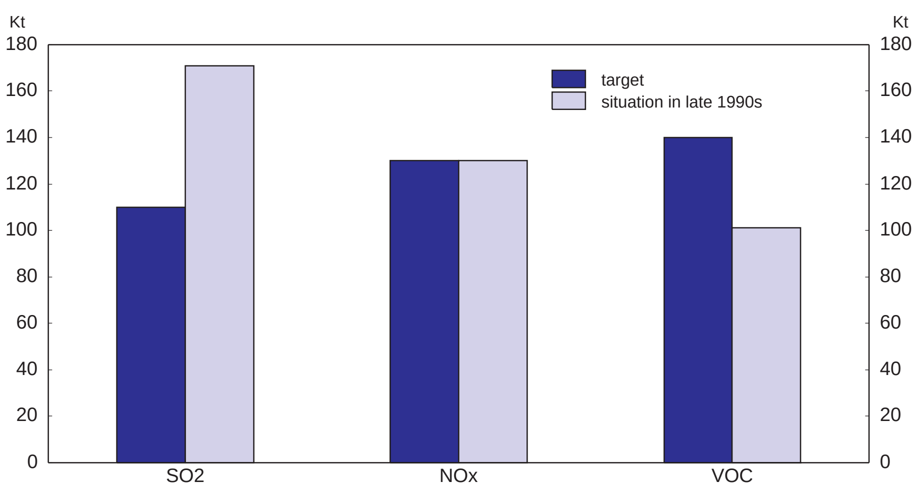
1. Australia: 1995-99 for sulphur dioxide; New Zealand: 1990-98; Mexico: 1994-98 for sulphur dioxide and VOCs and 1990-98 for nitrogen dioxide; Slovakia: 1990-98 for sulphur dioxide and nitrogen dioxide and 1990-97 for VOCs.
2. 1998 for Mexico, New Zealand and sulphur dioxide and nitrogen dioxide in Slovakia; 1997 for VOCs in Slovakia.

Source: Cooperative Programme for Monitoring and Evaluating of Long-Range Transmission of Air Pollutants in Europe (EMEP); World Health Organisation; OECD (2003e).

aim of cutting releases to 105 thousand tonnes, some 4½ per cent lower than called for by the 1999 Gothenburg Protocol to Convention on Long-Range Transboundary Air Pollution[94] (CLRTAP) (Figure 27). Significant abatement effort will be required to attain this goal. For emissions of other air pollutants subject to targets in the 1999 Gothenburg Protocol, actual emissions at the end of the 1990s were already below the established 2010 ceilings, and the challenge is to keep them there despite continued increase in economic activity. The transposition of EC directives into domestic law establishes targets for ambient air quality. These caps are currently exceeded at some monitoring stations and actions are required to comply with them.

Policies aimed at reducing emissions of atmospheric pollutants continue to rely on command-and-control regulation, some of them still coupled with subsidies, but are making increasing use of economic instruments. Emissions of traditional air pollutants (sulphur dioxide, nitrous oxides, carbon monoxide and particulate matter) and of "other pollutants" (150 odd substances) have been taxed since 1998. For instance a € 49 per tonne charge is levied on sulphur dioxide emissions from approximately 200 large plants that are responsible for about 90 per cent of total discharges. While the sulphur-dioxide emission charges provide an incentive to cut discharges at a low cost, there are concerns that emitters have avoided paying the full extent of the fees by underreporting their discharges and regional authorities have difficulties in collecting penalties for excess emissions. Even if they are fully enforced, the sulphur-dioxide emission charges are

Figure 27. **Emission of air pollutants: 2010 CLRTAP targets**



Source: OECD (2003e); For SO_2, OECD (2002b).

low compared with other countries which use economic instruments to control such emissions. For example, the charge in Sweden is € 1 600 per tonne. Moreover, they are low compared with typical estimates of the marginal benefits of reducing emissions, recently valued at more than € 5 600 per tonne for rural areas in the European Union and significantly higher for urban areas (Holland and Watkiss, 2003).

On top of the emission tax, releases of sulphur dioxide have been subject to tradable quotas since January 2002. Allowances were allocated to individual companies free of charge. In 2002, they traded between 5 and 7 euros a tonne (INERIS, 2003). Together with the emission charge, the market encourages abatement as long as it can be done at a lower cost than the total of the tax rate and the permit price, resulting in a cost-effective allocation of efforts. This is all the more so since a major restriction upon trade has been suspended until 2005. Companies in any of the 79 districts that do not attain their regional emission target were banned from buying quotas from outside the district to make up for the shortfall. For companies with emissions above their quota in such areas, the only option was to reduce their discharges irrespective of costs, a situation which blunted the effectiveness of the cap-and-trade scheme. Emission permit trading could also be used to attain the overall emission reduction associated with the EC Large Combustion Plant Directive, by invoking its "opt-out" clause, which would avoid resorting to the costly regulatory measures that are otherwise compulsory under the directive.

The application of new tighter emission standards for vehicles will ensure that new vehicles will be much less polluting than earlier models. The speed at which tighter emission standards translate into improved air quality will depend on how quickly the existing car fleet is renewed. The road tax for commercial vehicles is differentiated according to the engine size but not the emission standard of the vehicle. Motor fuels are differentiated according to their pollution content. In contrast to many OECD countries, higher polluting diesel fuel is taxed at a similar or higher rate than petrol. Fuel standards follow the "Euro III" directive of the European Union.[95]

Conclusions

The Slovak Republic has achieved an improvement in air quality since the early 1990s, but further cuts in emissions are required to honour international obligations. To attain targets in the least costly way, the authorities should build on their use of economic instruments in the past. In the near term, this would involve strict enforcement of the emission charge system in line with estimates of the external costs of such emissions. In the medium term, the planned emission trading system could serve as a cost efficient tool for abatement. It should especially be used to attain the objectives embedded in the EU directive on large combustion plants on the basis of the opt-out clause. Meanwhile, the ban on the importation of permits into areas where regional emissions are above target, which has been suspended, should be dropped altogether, except for those few places where local concentrations are a problem in themselves, as it is less costly to compensate for "excessive" emissions in one area by lower emissions elsewhere. For diffuse sources of air pollution, differentiation of the road tax for all vehicles according to their emission characteristic would be a useful device to speed up the renewal of the car fleet with less polluting vehicles. If need be, applying the fuel standards of the "Euro IV" directive before the 2005 deadline would bring emission reductions immediately.

Providing a sustainable income for the elderly

Main issues

Demographic developments in the Slovak Republic will soon be marked by an ageing and declining population. In the absence of corrective measures, the increase in the old-age dependency ratio would put upward pressure on public pension spending and erode the contribution base, and thus destabilise public finances. Pension reforms have been high on the policy agenda in recent years, and parliament approved important changes to the public retirement income system in May 2002 and September 2003 but still left the system unsustainable in the long run. The main issue continues to be to make the public pension system financially sustainable without compromising the income adequacy of the elderly or reducing the production capacity of the economy.

Performance

With the ratio of old-age pensioners to contributors expected to more than double from now to 2050, ageing will strongly influence public finances over this period (Table 31). At present, the outlays of public pay-as-you-go old-age pension system amount to 8 per cent of GDP, and the system is in a deficit of 1 per cent of GDP, notwithstanding very high pension contribution rates at 28 per cent. Prior to the 2002 pension reforms, official projections suggested that the deficit would widen steadily to 6 per cent of GDP by 2050, with about a half of the deterioration coming from higher pension outlays and the remainder from falling contributions (Figure 28).[96] With the 2002/03 pension reforms, official projections indicate that the deficit of the public PAYG pension system could be contained at under 3 per cent of GDP by the mid-century (see below for detail). Nonetheless, the pension system would still be financially unstable.

In 2002, before income tax, average old-age pensions were equal to just over 45 per cent of the average gross wage. However, with pension income not being subject to tax, the net replacement rate was significantly higher. Reflecting

Table 31. **Performance indicators: sustainable retirement income**

	Projected increases in old age pension spending	Low income rate of the elderly[1]	Relative disposable income of the elderly[1]	Private pension funds 1999	Age of withdrawal, 1994-1999	Projected increases in old age pension spending	Participation rate, 2001, per cent		
								Aged 55-64	
	Change in per cent of GDP 2000-2050	Per cent of the elderly with income less than 50% of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female	Aged over 65	Male	Female
Australia	1.6	16.1	67.6	63.8	59.7	61.3	6.0	60.0	36.9
Austria	2.2	14.9	86.6	3.6			2.8[1]	42.1[1]	17.5[1]
Belgium	3.3	13.8	77.9	6.1			1.3	36.6	15.7
Canada	5.8	2.5	97.4	45.7	62.6	61.1	6.0	61.3	41.7
Czech Republic	6.8			3.8			4.0	55.0	24.5
Denmark	2.7	9.2	73.0	24.4	62.4	61.5	4.6	65.5	51.8
Finland	4.8	7.5	79.0	10.7	59.8	60.0	3.7	51.2	49.5
France	3.9[2]	10.7	89.7	6.3	59.3	59.8	1.2	43.8	34.1
Germany	5.0	10.4	85.6	3.2	60.5	60.8	3.0	50.6	32.4
Greece		29.2	76.8	4.6	61.7	62.2	5.0	57.0	23.6
Hungary	1.2	6.0	85.2	2.2			3.1	36.3	15.4
Iceland				86.0			19.9	92.8	81.7
Ireland		16.7	74.6	57.8			7.9	66.1	29.5
Italy	–0.3	15.3	84.1	3.0	59.3	58.4	3.4	57.8	26.6
Japan	0.6			18.7	69.1	66.0	21.8	83.4	49.2
Korea	8.0			3.2	67.1	67.5	29.6	71.3	47.9
Luxembourg		6.7[3]		. .			0.0	38.1	14.3
Mexico		32.9	85.3	2.4			30.5	80.5	27.6
Netherlands	4.8	1.9	86.3	119.3	61.6	60.1	3.1	52.0	26.9
New Zealand	5.7			. .			8.6	74.6	51.7

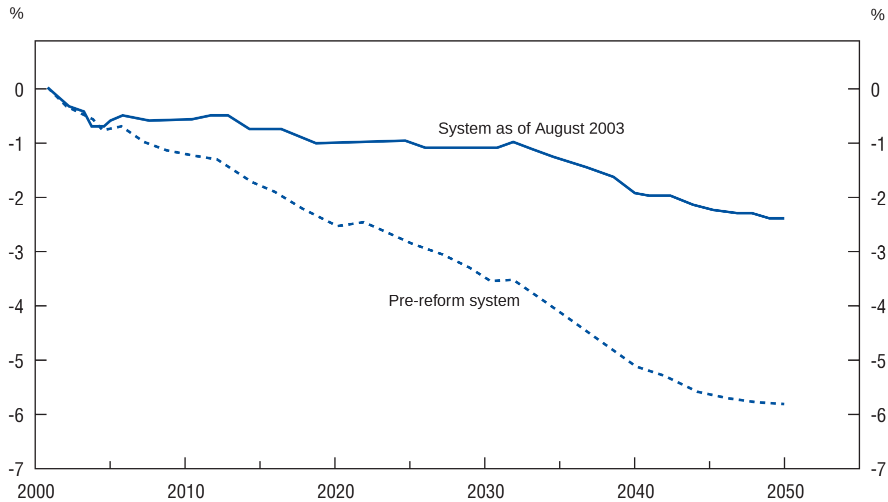
Table 31. **Performance indicators: sustainable retirement income** (*cont.*)

	Projected increases in old age pension spending	Low income rate of the elderly[1]	Relative disposable income of the elderly[1]	Private pension funds 1999	Age of withdrawal, 1994-1999	Projected increases in old age pension spending	Participation rate, 2001, per cent		
								Aged 55-64	
	Change in per cent of GDP 2000-2050	Per cent of the elderly with income less than 50% of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female	Aged over 65	Male	Female
Norway	8.0	19.1	74.1	7.4	64.2	64.7	13.2	73.6	63.2
Poland	–2.5	8.4[3]		. .			7.5	41.5	24.1
Portugal				11.4	65.3	66.5	19.0	63.7	41.9
Slovak Republic				**0.3**			**1.1**	**43.0**	**11.2**
Spain	8.0	11.3[3]		2.3	61.1	61.1	1.6	61.4	23.6
Sweden	1.6	3.0	89.2	. .	63.3	61.8	9.4	73.5	67.4
Switzerland		8.4[3]		97.3[4]			11.4	82.4	56.1
Turkey		23.1	92.7	. .			18.1	50.8	18.4
United Kingdom	–0.7	11.6	77.8	84.1	62.0	61.2	4.8	64.4	44.6
United States	1.8	20.3	91.7	74.4	65.1	64.2	13.1	68.1	53.0

1. Förster and Pellizzari (2000).
2. Secretariat estimate in OECD (2001).
3. Smeeding (2002).
4. Data for 1998.

Source: Förster and Pellizzari (2000); Jesuit and Smeeding (2002), *Luxembourg Income Study*; OECD, *Labour Force Statistics*, Scherer (2002).

Figure 28. **Financial balance of the public pension system relative to GDP 2000-2050**



Source: Ministry of Labour, Social Affairs and Family.

the traditional use of the pension system as an income redistribution tool, replacement rates are much higher for lower-income than higher-income earners. For example, at the level of half and twice the average earnings, the replacement rates would be close to 95 and 25 per cent respectively. With very low capital income, the elderly are largely dependent on state pensions which make up 95 per cent of old-age pensioners' income. This is a departure from the situation that prevailed in the late 1980s when more than a quarter of all pension recipients supplemented their state retirement income with earned income. Less then 10 per cent have been doing so in recent years, partly reflecting the generally poor labour market situation and the particularly low labour force participation of men and women after 60 and 55, respectively.

Policy

For some time there has been a consensus that the current PAYG system should be replaced by a three-pillar system with less emphasis on redistribution. The 2002 reform was confined to changes to the public PAYG system, which were amended in September 2003. However, the government has been preparing the introduction of a second pillar, and in 2002 privatisation proceeds equivalent to over 6 per cent of GDP were allocated to finance the transition costs to a funded pillar. Nonetheless, the first pillar PAYG income-related pension is still expected to be the dominant income source for older people in the future.

The key elements of the reforms to the public pension system included:

– Aligning women's standard retirement age to men's, namely 62 following the 2002-2003 reform. Currently, the standard retirement age for women ranges from 53 to 57 according to the number of children. It will rise by nine months annually from 2004.

– Linking pensions to contributions more strongly by making state retirement income dependent on contributions throughout working life, effectively introducing a form of "notionally defined contribution" system.[97]

– Weakening the extent of income redistribution via the pension system. For instance, the ceiling above which earnings are not taken into account for determining pension entitlements has been raised from 78 per cent of the average wage to 125 per cent.

– Indexing pensions to the average of consumer price inflation and wage inflation instead of the previous practice of indexing pensions to the higher of the two. Changes in indexation are expected to reduce future spending by 2 percentage points of GDP.

The PAYG pension reform will sharply reduce public retirement income for low-income earners, putting pressure on the social assistance system to provide resources for the elderly. Indeed, at half the average earnings the gross replacement rate could drop from around 95 to 50 per cent. However, this downward adjustment will materialise gradually, new benefit calculation rules becoming fully applicable only in 2008. Trend growth in earnings during this period may partly offset the decline of the replacement rate, helping maintain the lowest pensions above minimum standards. Otherwise, some of the saving in pension expenditure from the 2002-2003 reform could be offset by higher spending on non-pension social transfers.[98]

The new pension rules will somewhat raise the effective ages of retirement from their current low levels. The increase in the standard retirement age for women can be expected to prolong their working lives. Also, the closer link between pensions and contributions will reduce the financial disincentives to work at older ages. In the old system continued work at older ages resulted in little or no increases in pensions though contributions had to be paid at a high rate. This implicit tax on work at older ages has been lowered with the 2002/03 reform, and postponement of retirement is rewarded by a 6 per cent increase in pensions for every year of continued work. Nonetheless, there are still financial penalties associated with continued work at older ages,[99] and the low standard retirement age, even after the reform, continues to act as a barrier for labour force participation at older ages. Moreover, pension recipients that receive social assistance benefits will be facing an implicit marginal tax rate of up to 75 per cent, thus discouraging them from supplementing their resources with earned income.

By the end of 2003, there was still no final parliamentary decision on the second-pillar mandatory funded pensions. According to a government sponsored draft law, a second pillar would be established from 2005, forcing newcomers to the Slovak labour market to open up mandatory private pension accounts with licensed pension funds. Current contributors to the PAYG system could opt for the new system between January 2005 and June 2006. The draft bill envisages that under the new system 9 per cent of gross wages would go towards private accounts, 9 per cent to the PAYG system, and 2 per cent to a reserve fund that is designed to help finance the deficit of the PAYG system arising from the redirection of a part of the pension contributions to private accounts. In the long term, the funded scheme would strengthen the economic pillar of sustainable development through further reducing the implicit tax on continued work at older ages, thus stimulating labour supply, and increasing national saving. However, as the reserve fund will likely be insufficient to compensate for the loss of contributions of those participating in the funded scheme, the government will have to step in with budgetary resources in order to honour its obligation to persons that are still in the old system. Without corrective actions, public finances would weaken. For example, the proposals outlined above could cost the budget around 1 per cent of GDP per yearin the short-term. The accumulated costs would in this case far exceed the funds from privatization that have been set aside to finance the transition. The shortfall could be covered with cuts in public expenditure or with a "transition" tax, but in the latter case at the cost of postponing the beneficial supply effects of the funded scheme.

Conclusions

Notwithstanding the 2002/03 pension reform, the public retirement system is still not financially sustainable and costs associated with retirement income provision have been shifted to other parts of the budget. The best way to tackle the fiscal challenges without compromising income adequacy or weakening the economy is to increase the effective age of retirement substantially. A first step in this process should be to further raise the standard age of pension entitlement from 62 to 65. Additional measures should aim at further lowering, and ultimately eliminating, the implicit tax on continued work at older ages, notably by subjecting minimum subsistence benefits to job search requirements. Giving a greater role to funded pensions could be helpful in this regard provided that measures – preferably spending cuts – are taken to finance the associated fiscal costs in the transition period. The authorities should also ensure that early retirement routes are not opened up as they strive to prolong working lives.

Notes

1. See Sabol and Hošková, 2003.
2. Around 5 per cent, up from 4 per cent a year ago. See monthly Dun & Bradstreet reports on the creditworthiness of 5 000 Czech and 1 000 Slovak firms About three quarters of endangered firms (category IV) are likely to go bankrupt within a year. Their likelihood of bankruptcy is 150-times higher than among the firms with best payments discipline (category I) (*www.dbis.cz/speng/press/press_release_0603.htm*).
3. Under the assumption that one quarter of employment in loss-making enterprises might disappear, which would imply a loss of about 7 per cent of total employment, and that rationalisation in the public sector would reduce the share of general government employment in total employment to the OECD average, which would mean a loss of about 3 per cent of total employment, the total number of vulnerable jobs may be estimated at around 10 per cent of total employment.
4. The new tax system, with a higher deductible threshold, will increase the take-home pay of low-skilled workers and may exert a moderating impact on wages.
5. OECD *Economic Survey, Slovak Republic*, June 2002.
6. For the year ending 31 December 2002, the National Bank of Slovakia reported a loss of SKK 24 836 million, with revenues of SKK 45 104 million and costs of SKK 69 940 million. The losses originated mainly from foreign exchange transactions (see table below). For 2003, a loss of similar size can be expected.

Revenues and costs of the NBS in 2002-03
(SKK millions)

	2002	January-September 2003
Financial revenues	44 897	30 183
Realised exchange rate gains	15 463	16 294
Unrealised exchange rate gains	–1	17
Financial costs	–67 946	–47 368
Realised exchange rate losses	–31 832	–24 716
Unrealised exchange rate losses	–7 513	–5 098
Operating revenues	207	143
Operating costs	–1 994	–1 315
Total loss	**–24 836**	**–18 357**

Source: National Bank of Slovakia.

7. Among Czech Republic, Hungary, Poland, Slovakia and Slovenia.
8. For the general government sector and on basis of government financial statistics (GFS).
9. The true level of public liabilities in 1993 was probably non-negligible, if one factors in the commitments resulting from bilateral agreements with the Czech Republic on the division of federal liabilities, and the implicit debt of the pay-as-you-go (PAYG) pension system.
10. The deviations of the 2003 expenditure and revenue outcomes from the budgeted and projected magnitudes are unevenly captured by existing methodologies. Certain non-tax incomes are not considered as current revenues and should be treated below the line in the ESA-95 methodology, while the continuing build-up of arrears in the education and health sectors are not properly recorded in the cash accounts. Transparency problems remain in the consolidation of the general government revenues and expenditures under decentralisation, and the quality of the 2002 and 2003 accounts is severely affected. These measurement problems are making difficult the accurate monitoring of the fiscal stance.
11. Historical and recent fiscal data is available on a GFS basis, while government's plans and projections are prepared on an ESA-95 basis.
12. The Ministry of Finance estimates that savings in government non-wage consumption of up to 1.5 per cent of GDP are technically possible within a four years horizon.
13. The authorities sought international assistance in analysing the long-term fiscal pressures and assessing available reform options with an aim to transfer the modern techniques of medium-term fiscal budgeting, functional programming and treasury and debt management in Slovakia. The Ministry of Finance (MOF) announced in April 2003 that the World Bank (WB) will provide a US$5.6 million 4-year loan for fiscal reform. Although its terms have not been specified, the loan will be earmarked for projects aimed at supporting the process of preparation of state budgets. This should include the improvement of the macroeconomic analysis and governance of the state treasury system. The WB equally supports a project to improve the analysis of the "economic impacts of legislation" and a WB judicial expert recently joined the Ministry of Justice. The US Treasury advised the MOF in 2000-2001 for the introduction of functional budgeting and programme budgeting techniques, including through a pilot application in co-operation with the Ministry of Education. European Commission also helps with project grants and "twinning operations" between the Slovak Government and the fiscal authorities of other European Union Member countries. Finally, the International Monetary Fund (IMF) initiated recently a "Public Expenditure Review" for the Slovak Republic.
14. Social security contributions will be reduced from 50.8 to 46.5 per cent of total wage costs as of January 2004. Further cuts will be needed in the future to reduce the high unemployment rate. Both labour tax wedges and labour supply-demand imbalances are largest of the low end of the labour market and need to be urgently addressed (see Chapters Iand IV).
15. Partly hidden in Slovakia because of the off-budget payment arrears in the hospital sector, which are periodically "cleaned" by the government. These arrears reached 1.5 per cent of GDP in 2002 alone.
16. Among Czech Republic, Hungary, Poland, Slovakia and Slovenia.
17. The old-age dependency ratio is at present around 15-16 per cent against more than 20 per cent in other post-transition countries.

18. The country has a small size and no natural obstacles fragment the territory. Should transportation shortcomings be remedied, eastern regions could rapidly be fully integrated in the national economy and share its attractiveness as an investment location in Central Europe. Latest investor surveys confirm the discouraging impact of the transportation bottlenecks.
19. The health status of the population depends only partially on the quality of health services. It is equally influenced by factors such as income levels, education, nutrition, working conditions, etc.
20. World Bank monograph, 2002.
21. In the ESA-95 methodology and excluding bank restructuring costs. The deficit was planned to decrease from 4.7 to 3.3 per cent of GDP with bank restructuring costs.
22. According to a recent assessment of the road infrastructure by the World Bank "under-maintenance is eating away at the stock of transport infrastructure". To correct the current backlog in maintenance and to adapt capacities in both basic and high standard network would require a 2.3 fold increase in funding. The world Bank estimates that this situation is "unsustainable in anything more than the very short term".
23. See OECD *Economic Surveys of Slovakia*, 1996, 1999.
24. Specific chapters are created for state treasury and debt, these can be exceeded if financial circumstances require it.
25. Information by the State Audit Office.
26. Social security spending is subject to the largest overruns, notably in the health area. Health insurance funds clear their fiscal projections with the Ministry of Health, but unbudgeted cost increases, unfunded pharmaceutical bills and ex-post deficits of hospitals have became common.
27. Expenditures in the electoral year 2002 were massively exceeded by pension and wage increases voted in the course of the year.
28. In 2003, the government could use part of its limited privatisation revenues to reduce debt.
29. "Old environmental burdens" (OEB) were estimated to reach SKK 21 billion, or around 2 per cent of GDP, by the Ministry of Environment, of which SKK 12 billion for contaminated territories and SKK 0.34 billion for the sanitation of former Soviet military bases. There are also other higher estimates of environmental commitments (see section below on Sustainable Development).
30. The parameters of the pension system are not stabilised and make the calculation of pension liabilities hazardous (see below).
31. These guidelines were based on the US and European experiences with functional budgeting and on the advice given by these countries' budgetary authorities.
32. Including the Ministry of Education, the Supreme Court and the Academy of Sciences.
33. This scheme requires tariff increases of 40 per cent in residential electricity and of more than 100 per cent in residential gas. Because of the expected impact on inflation and real incomes (administered prices account for nearly 20 per cent in the consumer basket) a gradual adjustment paths is planned.
34. In exchange of the lump sum subsidies received ZSR committed to stop all informal borrowing and arrear-building, and to close 25 regional lines. It is early to tell if outcomes are conforming the terms of the agreement – as loopholes remain numerous in the railway system.

35. High risk guarantees will be conservatively reported at 100 per cent of face value.
36. See Diamond (2002).
37. Sub-central governments obtain only a very limited share of total tax revenues. This share amounted to only 5 per cent for municipalities in 2001.
38. As they do in many Slovak regions.
39. Over-reliance on central government grants may shift the focus of sub-central government actions on negotiating and bargaining for additional subsidies rather than achieving savings. The problem is frequently faced in countries using earmarked grants based on ex-post actual costs to fund local public services, notably in health, education and employment assistance areas, such as Ireland, Switzerland and until recently Italy (see Joumard and Kongsrud, 2003).
40. There is mounting evidence of arrears accumulation and unauthorised debts in the education and health sectors in 2002 and 2003, when the governance of these sectors has remained in a limbo between central, regional and local governments. Political pressures to re-open the 25 loss-making local railway lines, often mediated by regional authorities, have also intensified during the same period.
41. This is best illustrated by the transportation and communication links between Northern Hungary and Southern Slovakia which remain very weak. The first region is labour-constrained while the second suffers high unemployment. Their labour markets are not integrated and interregional mobility is low. Policy coordination for road infrastructures and labour market schemes could enhance regional welfare.
42. A senior official from the Ministry of Interior in charge of staff reductions reported that the latest amendment to the Civil Service Act creates new bureaucratic obstacles to layoffs because each case has to be consulted with the Civil Service Office.
43. The decentralisation reform in the Czech Republic is faced with the same problem.
44. In the absence of consensus with teachers' unions, the concept of a performance-based pay system for primary and secondary school teachers was abandoned in 2003. Tertiary education teachers and their institutions have been given a choice between classical and performance-based pay systems.
45. OECD, *Education at a Glance*, 2003.
46. A recent OECD assistance programme for the introduction of Internal Financial Control Systems in Slovak public administration stressed the need for re-training: "Many of our recommendations, if implemented, would represent further complex and significant changes to current working practices…In principle, a budgetary organisation will need an accounting system with much the same capabilities as a medium-sized business company… The accounting system will not only be a system for financial control but also an important tool for the management of the budgetary organisation." Need for re-training was also underlined for fighting fraud: "There is very little experience to effectively investigate fraud. Attention is to be given to adequately resourcing investigation teams and to have them provided with appropriate training" (OECD, 2003f).
47. The Central Bank recently issued a warning on the excessively optimistic character of the projections associated with the pension reform.
48. Part of recent privatisation revenues, amounting to 6 per cent of GDP, have been set aside to finance this reform. Reserve needs are larger, however, as more than 1 per cent of GDP will be diverted away every year during a 20-30 years transition period.

49. Two of these three acts have already been passed. The one which will re-define the universal benefit package is in the inter-ministerial review process and is expected to be voted on early 2004.

50. Competition in social health insurance markets has not delivered the intended cost improvements for a range of reasons. Notably, insurers, even if they are allowed to do so, have not engaged in selective contracting with providers or negotiated with them improvements in quality or better managing of care, particularly in countries where historically insurers had an obligation to contract with all providers.

51. This process will be further accelerated by the integration with the EU markets in pharmaceuticals, medical equipment and health professionals. A recent estimation of the prospective fiscal cost of wage and price equilibration in the health sector projected sizeable spending pressures from this process in the neighbouring Czech Republic. See OECD *Economic Survey of the Czech Republic*, 2003.

52. Recent surveys on perceptions of corruption by the business sector are available on the website of the Slovak chapter of Transparency International (*www.transparency.sk*).

53. In contrast, the Czech authorities appear to have been more successful to date in their combat with economic crime. A number of former high-level officials, including a former Minister of Finance, were convicted. Although both countries share high levels of corruption, the Czech legal system appears to be more robust in terms of the quality of legislation and enforcement. This may well result from the lack of a genuine legal tradition in Slovakia prior to the split of the Czech and Slovak Federal Republic at the end of 2002; until then, Czech and Slovak jurisprudence was mostly Prague-centred. The most experienced law-enforcement authorities were also based in the Czech part of the former Federation.

54. To improve the situation, the government hired 400 officials in 2003 to process routine court cases and another 200 are to be employed in 2004.

55. The government has prepared legislation to streamline appeals procedures that should become effective within a year.

56. One recent manifestation is the relatively low proportion of Slovak adults (36 per cent) who believe that the planned conflict-of-interest legislation should also apply to regional governments (*www.transparency.sk*).

57. According to the research commissioned by Transparency International Slovensko, foreign-invested corporations introduce higher standards of business ethics to Slovakia than those prevailing among domestic firms. Such demonstration effects are valuable. They are likely to be reinforced by the declining relevance of one-off "games" such as privatisation and the growing influence of repeated "games" such as continuous business activity where the mutual adherence to rules is associated with positive payoffs. See "Ako vnímajú korupciu podnikatelia", Hospodárske noviny, 27 August 2003.

58. The new regime ought to liberate the Commercial Register staff from the time-consuming burden of examining the material substance of the documents submitted, enabling them to focus instead on procedural aspects of the registration process. This implies that the market actors engaging in transactions with the newly registered firms will incur the costs of collecting information on the background of new entrants.

59. See the discussion of vulnerable jobs and the related methodological note in Chapter I.

60. See the interview with the Minister of Justice, Trend, 3 July 2003.

61. This framework is based mainly on the legislation that entails a simplification of ownership transactions (Act 175/1999), investment incentives similar to those in neighbouring countries (Act 565/2001), tax relief (Act 366/1999), job creation and retraining subsidies (amendments to Act 387/1996), support for industrial parks (Act 193/2001), and state aid (Act 434/2001).
62. In addition to SE, the group of strategic companies include entities partly sold to strategic investors (Slovak Gas Company, Transpetrol, Slovak Telecom, Slovak Insurance Company, Slovak Savings Bank) as well as fully state-owned entities (Slovak Water Company, Slovak Post, Slovak Railways and State Forest Enterprises) and state-controlled regional bus operators. The government decided recently to privatise strategic firms on a case-by-case basis, reserving the right to sell all shares. The relevant amendment to the Strategic Companies Act is yet to be approved by Parliament.
63. See Bella and Durkovic (2003) for a detailed discussion. See also "Dispute Between Slovak Telecom and eTel Continues", ISI News, August 2003.
64. See "Ability of Telecommunications Office to Use its New Powers Doubted", ISI News, September 2003.
65. In July 2002, the Telecommunication Office of the Slovak Republic granted Profinet.sk (an internet service provider) a GSM and UMTS license, after it was the only bidder for the combined GSM/UMTS license and thereby becoming the third mobile operator in the country. However, in September 2002 both the GSM and UMTS licenses were revoked as Profinet.sk failed to come up with the first installment of the license fee in time.
66. With an annual consumption of more than 40 GWh.
67. As of 30 June 2003.
68. Actually, some households have apparently experienced large price increases along with deteriorating service standards. The plight of consumers dealing with monopolistic energy distributors has often been described in the Slovak daily press. See *e.g.* "Energetika zostáva monopolom", H*ospodárske noviny*, 7 May 2003.
69. This persuasion by the competition authority was successful in the case of the power industry where the transmission grid was split from the dominant generator and controlling stakes in regional distributors sold to different strategic investors. However, the gas utility (SPP) was privatised as a whole.
70. For instance, this highest court of appeal reversed in June 2003 a competition authority decision detecting an abuse of dominant position by the incumbent telephone operator (ST).
71. This distribution is based on NBS statistics pertaining to newly drawn loans in the non-financial business sector for the first 4 months of 2003. No comparable data are available for earlier periods.
72. For details of the loan programme schemes see National Agency for Development of Small and Medium Enterprises (2002), pp. 46-7.
73. The completion of this project has been time consuming because of consultations and co-operation between existing supervisory authorities.
74. Kontinuita had 5 per cent of the life insurance market in June 2003.
75. The maximum compensation awarded to a car accident victim in Slovakia last year was about 4 times higher than the maximum amounts awarded by courts in Germany or the

United Kingdom, 10 times higher than the maximum amount in Spain and more than 20 times higher than in the Czech Republic. See Trend, 12 June 2003.

76. As of 30 June 2003.
77. In no-fault auto insurance regimes, there is no fault assigned in the case of an accident. The drivers involved submit claims to their own insurance companies and receive immediate compensation from them without any involvement of lawyers, courts and judges. Interpretable damages (pain, emotional distress, etc.) are usually not covered while compensation for injuries is restricted by pre-determined limits. No-fault auto insurance regimes are operated in some states of the US and British Columbia in Canada.
78. The mandatory buyout price cannot be less than the average stock value during the last 6 months preceding the takeover. In the Slovnaft case, the average share value was boosted from SKK 1 093 to SKK 1 379 by a single transaction taking place five days before MOL bought the majority stake. MOL asked Financial Market Authority for the approval of the takeover bid with the price of SKK 1 200 per share; this offer was rejected by the Financial Markets Authority. MOL subsequently asked Financial Market Authority for the approval of the takeover bid with the price of SKK 1 379 and this offer was accepted on 29 October 2003. However, MOL had not initiated the approved takeover bid by December 2003.
79. "Conservative", "Balanced" and "Growth-Oriented" pension funds are distinguished. Funds with higher risks will only be accessible to contributors with a long-term investment horizon, *i.e.* those remote from retirement. Persons near retirement will be allowed to invest in the safest instruments only.
80. Rather than creating a new and necessarily less experienced authority.
81. The previous OECD *Economic Survey of the Slovak Republic* (2002) included a special chapter on the labour market, focussing on high unemployment and the development of human capital.
82. The same ratio in other OECD countries with large government sectors amounts to 14.5 per cent in Spain, 16 per cent in Italy, 18 per cent in Portugal and 18 per cent in Belgium, all below Slovakia. France has a slightly higher ratio at 23 per cent.
83. The share of disability benefit recipients in the working-age population observed in Slovakia exceeds the comparable proportion in the Czech Republic, a country with similar rules, by 3½ percentage points.
84. The Slovak authorities now require at least one verified job application in the two-week reporting period. Many small businesses have reportedly reacted to the influx of unemployed job seekers by refusing to accept their job applications to reduce processing costs; others have started to provide bogus attestations in exchange for illegal side-payments.
85. According to a report prepared by the Trexima company (*www.trexima.sk*) for the Ministry of Labour, Social Affairs and Family, the share of the minimum-wage earners in the final quarter of 2002 ranged from 0.8 per cent in the Bratislava region to 1.5 per cent in the Presov and Trnava regions.
86. 2 per cent of households live in apartments that are subject to rent regulation.
87. See "Informácia o nákladoch na dopravu a ich vplyv na flexibilitu pracovného trhu a územnú mobilitu pracovnej sily" 25.03.2002, *www.employment.gov.sk*.
88. The insufficient capacity of Slovak universities has resulted in growing enrolment of Slovak students in academic programmes available in the neighbouring countries, especially in the Czech Republic. The 1999 bilateral treaty has provided Slovak citi-

zens with non-discriminatory access to Czech universities, which means that they do not pay any tuition fees. Given the absence of a serious language barrier, this has resulted in a rapidly growing number of Slovak university students in the Czech Republic. Improving business environment conditions could motivate many of these students to return home after graduation. In the past, many Slovak graduates found employment in the Czech Republic, taking advantage of the 1993 labour market treaty that provides free access for Slovaks to the Czech job market and *vice versa*.

89. Unfortunately, Slovakia did not participate in the 2000 student performance assessment in 28 OECD countries so that there are no reliable comparative data on the quality of its education system. Results of the 2003 comparative assessment of the OECD countries, including Slovakia, are not available yet.
90. Many Roma have been scholarised in primary education institutions specialised in the education of children with difficulties.
91. See Ministry of Environment (2001).
92. Air pollution issues in the Slovak Republic are discussed in greater detail in OECD (2002a).
93. For example, the cost of air pollution in the EU countries was estimated to be as high as 5 per cent of GDP in the early 1990s.
94. UNECE (United Nations Economic Council for Europe) is the secretariat for the Convention on Long-Range Transboundary Air Pollution. It addressed some environmental problems of the UNECE region and has been extended by eight protocols which identify specific obligations or measures to be taken by Parties and so lays down the general principles of international cooperation for air pollution abatement.
95. Directive "Euro III" No. 98/70 of 2000.
96. This degradation of the fiscal position relates to pensions only. Ageing will put additional pressure on public finances because of increasing health care expenditure.
97. New benefit formula based on "personal wage development points" reflecting the ratio of the employee's wage to the average wage during the contribution history will tighten the link between benefits and contributions.
98. In an early estimation based on simplifying assumptions, the Ministry of Labour and Social Affairs calculated that once the new benefit calculation system becomes fully applicable, up to 4 per cent of retiring men and up to 18 of retiring women may fall in the social safety net and qualify for additional social transfers.
99. Even the increase in pensions by 6 per cent for an additional year of work would not suffice to offset the costs of foregoing pensions for one year and paying contributions at the rate of 28 per cent.

Bibliography

Allan, W. and T. Parry (2003), "Fiscal Transparency in EU Accession Countries: Progress and Future Challenges", IMF *Working Paper*, No. WP/03/163.

Barosová, M. *et al.* (2002), EIRO *Comparative Study on Collective Bargaining Coverage and Extension Procedures – Report on Slovakia*, European Industrial Relations Observatory, Vienna.

Bella, T. and M. urkovi (2003), "The Internet and New Information and Communication Technologies", *Slovakia* 2002: A *Global Report on the State of Society*, Institute of Public Affairs, Bratislava.

Bleaney, M. *et al.* (2001), "Testing the endogenous growth model: public expenditure, taxation, and growth over the long run", *Canadian Journal of Economics*, Vol. 34, No. 1.

Corricelli, F. and V. Erolani (2002), "Cyclical and structural deficits on the road to accession: fiscal rules for an enlarged European Union", *Transition Economics Discussion Paper Series*, No. 3672, Centre for Economic Policy Research, London.

Dethier, J. J. (2001), "Effectiveness of Decentralization in Hungary and Slovak Republic", *Unpublished mimeo*.

Diamond, J. (2002), "Performance Budgeting – Is Accrual Accounting Required?", IMF *Working Paper*, No. WP/02/240.

Diamond, J. (2003), "From Program to Performance Budgeting: The Challenge for Emerging Market Economies", IMF *Working Paper*, No. WP/03/169.

Fajnzylber, P., W.F. Maloney (2001), "How Comparable are Labor Demand Elasticities across Countries", *World Bank Working Paper*.

Förster, M. and M. Pellizzari (2000), "Trends and driving factors in income distribution and poverty in the OECD area", OECD *Labour Market and Social Policy Occasional Papers*, No. 42, Paris.

Giavazzi, F. and M. Pagano, "*Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries*", Universita di Bologna, CEPR, and NBER/Universita Di Napoli and CEPR.

Gleich, H. (2003), "Budget institutions and fiscal performance in central and eastern European countries", Working Paper Series, No. 215, European Central Bank, Frankfurt.

Government of the Slovak Republic (2002), "Priority vlády SR vo vzahu k rómskym komunitám na rok 2002", Bratislava.

Hamermesh, D.S. (1993), *Labor Demand*, Princeton University Press, New Jersey.

Heritage Foundation (2003), *Index of Economic Freedom*, The Heritage Foundation, Washington, D.C.

IMF (2003), "Slovak Republic – Staff Report for the 2003 Article IV Consultation", July 8, 2003.

Institute for Management Development (2003), IMD *World Competitiveness Yearbook* 2003, IMD, Lausanne.

International Energy Agency (2001), *Co_2 Emissions from Fuel Combustion*, OECD, Paris.

International Energy Agency (2003), *Energy Prices and Taxes*, fourth quarter, OECD, Paris.

Italianer, A., (2003), "From Accession to Adopting the Euro". Paper presented at the conference on "From accession to adopting the Euro" (21 November), Warsaw.

Jesuit, D. and T. Smeeding (2002), "Poverty and income distribution", *Luxembourg Income Study Working Paper*, No. 293, January.

Joumard I. and P. M. Kongsrud (2003), "Fiscal relations across government levels", OECD *Economics Department Working Paper* No. 375, Paris.

Kuijs, L. (2002), "Monetary Policy Transmission Mechanisms and Inflation in the Slovak Republic", IMF *Working Paper*, No. WP/02/80.

Ministry of Labour, Social Affairs and Family (2003), *Návrh stratégie podpory rastu zamestnanosti prostredníctvom zmien sociálneho systému a trhu práce*, Bratislava.

Ministry of Transport, Posts and Telecommunications of the Slovak Republic (Jan. 2000), "Updating, Referring and Specification", *Principles of the State Transport Policy of the Slovak Republic*, Bratislava.

Natalucci, F.M., and F. Ravenna (2002), "The Road to Adopting the Euro: Monetary Policy and Exchange Rate Regimes in EU Candidate Countries." International Finance Discussion Papers 741. Federal Reserve Board, Washington, D.C.

National Agency for Development of Small and Medium Enterprises (2002), *State of Small and Medium Enterprises in the Slovak Republic*, NARMSP, Bratislava.

Nuti, D.M. (2002), "Costs and Benefits of Unilateral Euroization in Central Eastern Europe". *Economics of Transition* 10(2): 419-444.

OECD (2000), *Economic Surveys: Hungary*, OECD, Paris.

OECD (2002a), *Economic Surveys: Slovak Republic*, OECD, Paris.

OECD (2002b), *Environmental Performance Review Slovak Republic*, OECD, Paris.

OECD (2003a), *Communications Outlook*, OECD, Paris.

OECD (2003b), *Education at a Glance*, OECD, Paris.

OECD (2003c), *Society at a Glance: OECD Social Indicators*, OECD, Paris.

OECD (2003d), *Economic Surveys: Czech Republic*, OECD, Paris.

OECD (2003e), OECD *Environmental Data Compendium*, OECD, Paris.

OECD (2003f), "SIGMA Peer Assistance to the Public Internal Financial Control System in the Slovak Republic", *Short SIGMA Paper*, October 2002-February 2003, OECD, Paris.

PAS (2002), *Business Environment Report: Slovak Republic* 2002, PAS Business Alliance of Slovakia, Bratislava.

Procházka R., B. Jablonka, D. Lipšíc, V. Pirosik and E. Valko (2003), "Rule of Law, Legislation and Law Application", *Slovakia* 2002: A *Global Report on the State of Society*, Institute of Public Affairs, Bratislava.

Sabol, T. and A. Hošková, 2003, "Foreign Direct Investment in the Slovak Economy and its Influence on the Business Sector". BIATEC XI, National Bank of Slovakia, Bratislava, pp. 19-22.

Scherer P., (2002), "Age of withdrawal from the labour force in OECD countries", *Labour Market and Social Policy Occasional Papers*, No. 49.

Statistical Office of the Slovak Republic (2002), *Statistical Yearbook of the Slovak Republic*, Bratislava.

Toth, J. and A. Chudik (2002), "What is the consequence of 14 per cent + public wage growth in 2002?", *Slovak and Inflation Wage Models: Economics Paper*, No. 1, ING Bank N.V., London.

Vao, B. (2001), *The Demographic Characteristics of Roma Population in Slovakia*. Infostat, Bratislava.

Vao, B. (2002), *Projection of Roma Population in Slovakia until 2025*. Infostat, Bratislava.

Vaeka, M. and I. Radiová (2002), "Social exclusion and double marginalization of the Roma in the Slovak Republic after 1989," in B. Funke and L. Pizzati, eds, Labor, *Employment, and Social Policies in the EU Enlargement Process*, World Bank, Washington, D.C.

Vaeka, M. (2003), "Roma", *Slovakia 2002: A Global Report on the State of Society*, Institute of Public Affairs, Bratislava.

Whelan, K. (1999), "Tax incentives, material inputs and the supply curve for capital equipment", *Finance and Economics Discussion Series*, No. 1999-21, Federal Reserve Board, Washington, D.C.

World Bank (2001), *Slovak Republic: Living Standards, Employment and Labor Market Study*. Report No. 22351 – SK., Washington, D.C.

World Bank (2001), *Slovak Republic: Living Standards, Employment and Labor Market Study*: No. 22351.

World Bank (2002), *Slovak Republic: Development Policy Review: Summary Report Volume I & II*, Washington, D.C.

Zemanoviová, D. and E. Siáková-Beblavá (2003), "Transparency and Corruption", *Slovakia 2002: A Global Report on the State of Society*, Institute of Public Affairs, Bratislava.

Annex

Chronology of recent events

2002

July

The government sealed the largest privatisation deal up to then by selling a 49 per cent stake in gas utility *Slovensky Plynarensky Priemysel* to a consortium of Germany-based *Ruhrgas*, France-based *GdF* and Russia-based *Gazprom*.

Germany-based *Allianz* acquired Slovakia's largest insurance company *Slovenska Poistovna*, following approval by the antimonopoly authority.

August

The government approved a minimum wage increase by 13 per cent, effective from October 2002.

September

General elections led to the formation of a four party centre-right coalition government under prime minister Mikulas Dzurinda.

The antimonopoly office approved the sale of 49% in regional power distributors *Zapadoslovenska Energetika* (ZSE), *Vychodoslovenska Energetika* (VSE), *Stredoslovenska Energetika* (SEE) to, respectively, Germany-based E.ON *Energie*, Germany-based RWE *Plus*, and France-based *EdF*.

October

Electricity market liberalization became effective, enabling large corporate consumers to import electricity from abroad.

The National Bank of Slovakia lowered its two-week sterilization repo rate from 8.25 per cent to 8.0 per cent.

November

Rating agencies *Moody's* and *Fitch* upgraded the outlook on Slovakia's long-term foreign currency bonds to "A3" from "Baa3" and to "BBB-" from "BB+", respectively.

Parliament approved the reduction of the basic VAT rate from 23 to 20 per cent and an increase in the lower VAT rate from 10 to 14 per cent. It also approved an increase in excise taxes on tobacco and tobacco products.

The National Bank of Slovakia cut its key interest rates by 150 basis points.

December

The Telecommunications Office issued a license to operate a wireless cable network via MMDS to *Satro*, which became a competitor to the Slovakia's dominant cable network operator, UPC *Slovensko*.

Standard & Poor's Rating Service raised its long-term foreign currency ratings on the Slovak Republic to "BBB" from "BBB-".

2003

January

Administered prices for natural gas, heating, electricity, housing, transport, water and sewage were increased substantially.

The mortgage rate subsidy was reduced from 4.5 to 2.5 percent.

France-based PSA *Peugeot Citroën* announced its decision to build a new assembly plant in Slovakia at an investment cost of about € 700 million. The plant is scheduled to be operational in 2006, have an annual capacity of 300 000 cars, and employ 3 500 people.

Workers at the national railway company went on strike over the scheduled cancellation of passenger transport on 25 regional lines and associated job-cuts.

February

Parliament approved the abolishment of the Privatization Ministry, effective in April 2003.

March

Bratislavska Regionalna Kolajova Spolonost (BRKS) was established as the first regional railway company in Slovakia, initially operating two lines.

The Bratislava Stock Exchange twice suspended trading in shares of Slovakia's largest crude oil refiner *Slovnaft*, in response to suspicion about market manipulation in anticipation of the takeover of the company by Hungary-based MOL.

The Slovak Television Council approved a new programming and organisational structure for public service Slovak Television (STV), involving reductions in the workforce by 60 per cent by June 2003.

International rating agency *Fitch* further upgraded the Slovak Republic's long-term foreign currency rating to "BBB" from "BBB-".

April

Parliament approved a reduction in the state subsidy on private housing construction savings from 20 per cent to 15 per cent, effective January 2004.

May

At a referendum on Slovakia's European Union entry, 92.5 per cent of those who voted supported EU-membership. The turnout in the referendum was 52 per cent.

Parliament approved a revised Labour Code that increased the number of overtime hours employees can work from 150 to 250 hours per year and introduced new forms of part-time jobs up to twenty working hours per week, effective from July 2003.

Parliament passed a revision to the telecommunications law to unbundle local loops, change license proceedings and strengthen the powers of the market regulator, *i.e.* the Telecommunications Office.

Austria-based Meinl Bank acquired a majority stake in Banka Slovakia.

June

The World Bank approved a € 5 million Public Finance Management Project that aims to support Slovakia's public finance reform strategy.

July

Slovakia joined the agreement on the European Economic Area.

August

Excise taxes on tobacco, beer and mineral oils were increased.

September

The World Bank approved two health sector reform loans totalling € 66 million.

The National Bank of Slovakia lowered its key interest rates by 25 basis points.

The Confederation of Trade Unions (KOZ) organised a nation-wide one-hour general strike to support its demands concerning wage increases and pension reform.

October

The government decided to increase the minimum wage by 9 per cent, starting October 2003. Moreover, representatives of the government and the Confederation of Trade Unions (KOZ) signed a collective agreement in the public service. The document stipulates a wage increase of public sector employees by 7 per cent as of August 2004.

The government approved a draft pension law, which provides for the creation of a second capital funded pillar. The new system will be mandatory for newcomers to the labour market, while current employees would be able to choose between the new and the existing pay-as-you-go system.

November

The European Commission published a comprehensive evaluation report on Slovakia's EU membership preparations suggesting that Slovakia has reached a high level of alignment with the acquis in most policy areas. However, the report warned that Slovakia must take immediate and decisive action to address four issues in the areas of competition and agriculture if it is to be ready by the date of accession.

Parliament approved a bill on regional and district administrative offices that abolishes all 79 existing district offices. They will be replaced by 50 area offices, to be supervised by eight regional offices, as of January 2004.

Parliament approved the law on financing of elementary and secondary schools and school facilities, which from January 2004 introduces a new model of financing taking into account the number of the students and the size and type of the facility.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(10 2004 01 1 P) ISBN 92-64-02026-8 – No. 53403 2004
ISSN 0376-6438