Policy Brief

OECD

Economic Survey of the Slovak Republic, 2004

Summary

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. ■

This Policy Brief presents the assessment and recommendations of the 2004 OECD Economic Survey of Slovakia. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

oecd Observer

What key challenges does Slovakia face?

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 productivity, keeping inflationary pressures and external imbalances in check while core inflation continues to decline. At the same time, however, the Slovak economy suffers one of the lowest employment rates in the OECD area. Demand for 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.

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.

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.

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. ■

How can fiscal and monetary policies support growth?

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.

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 3.2-4.7 per cent in 2002 and within the target range of 2.1-3.6 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.

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.

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. ■

What can be done to reduce unemployment?

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 is low, substantial investment in adult education and training seems warranted in the Slovak context.

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. ■

Is the new institutional framework enforced effectively?

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.

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. ■

How can public services be improved?

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.

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.

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 micro-management 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.

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. ■

Is Slovakia doing enough to augment it's human and physical capital?

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.

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. ■

Are social security systems viable?

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 down-scaling the second pillar reform, delaying convergence with Maastricht rules, or seeking yet further spending cuts.

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. ■

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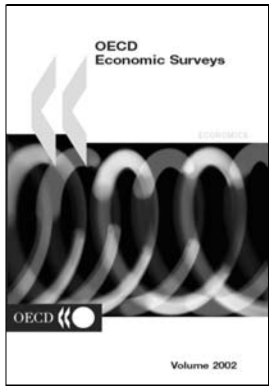

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