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OVERVIEW

Summary

The Slovak economy recovered very strongly after the global financial and economic crisis and will remain among the strongest in the OECD. However, job creation is disappointing, domestic demand remains subdued and the external drivers of growth risk fading away. The fiscal room gained in the run-up to euro accession quickly evaporated during the crisis, and public debt has increased considerably since 2008. The main priorities now are to restore public finances while fostering domestic drivers of growth and ensuring the funding of items to promote growth, such as education and active labour market policies. The government has put together a credible consolidation programme for debt stabilisation, but long-term fiscal sustainability issues remain unresolved. This *Economic Survey* makes recommendations on how to improve the fiscal framework, raise labour market performance, and strengthen outcomes of the education system.

The fiscal framework has a pro-cyclical bias and does not facilitate prioritisation according to the outcomes of the government programmes. The government should introduce spending ceilings as planned and adhere to them. It should strengthen monitoring and evaluation of spending programmes, for which the recently established Fiscal Responsibility Board can play a useful role. The structure of taxation should be made less harmful to growth, notably by raising property and environmental taxes and lowering taxes on low wages. The efficiency of the tax system should also be improved by combating tax evasion further and unifying the tax collection as planned. Finally, monitoring the sustainability and adequacy of old age income replacement is crucial.

Educational outcomes are below the OECD average and the education system should be made more inclusive. Efficiency could be improved by using already available school evaluations to raise the quality of teaching. More resources should also be allocated to teacher remuneration and to support of disadvantaged pupils, in particular for the development of pre-school education and the integration of Roma children in the mainstream education system. Transition from school to work of vocational education graduates is weak. Cooperation with employers needs to be enhanced and the acquisition of professional experience during studies should be fostered by developing work-based vocational training.

The crisis raised unemployment, which has increased by 4 percentage points since 2008. Long-term unemployment and regional disparities are high by international standards. The labour market experience of youth, the low skilled and the Roma population is particularly poor. More emphasis should be placed on activation and other active labour market policies, which are currently insufficiently developed. The public employment service needs to be reformed to better implement activation measures, with more resources allocated to the placement services and to the evaluation of programmes. The registration of social benefit recipients with some ability to work should be made mandatory to encourage job search activities and encourage them to enrol in active labour market measures.

Key policy recommendations

Improving the fiscal framework

- Further strengthen the medium-term spending framework by introducing spending ceilings as planned, and adhere to them.

- Increase the scope for monitoring and evaluation of spending programmes. Widen the use of performance elements in financing, contract renewals and compensation.

- Continue efforts to improve tax collection by implementing the transition towards an integrated tax collection system. Further combat tax evasion by strengthening monitoring activities.

- Reform the structure of taxation to make it less harmful to growth, notably by increasing real estate and environmental taxes and lowering labour taxes paid by employers at lower wage levels to encourage greater labour demand.

Raising educational outcomes in a cost-efficient way

- Remove premiums to eight-year grammar schools as planned and strengthen incentives for the integration of pupils with special needs in the standard system.

- Improve the use of available evaluations to identify dysfunctional schools as well as best practices.

- Increase the wages of teachers together with structural measures increasing the efficiency of the system such as consolidating the network of schools, increasing the classroom size and widening the scope for performance-related pay.

- Raise support to disadvantaged pupils. Further encourage participation of children from low-income families and Roma in pre-primary education and the integration of Roma in mainstream education.

- Foster acquisition of professional experience during studies and work-based vocational education and training by creating a legal framework for a dual apprenticeship system.

Increasing employment through activation and better targeted support

- Encourage job search activities and participation in Active Labour Market Policy (ALMP) by all benefit recipients with some ability to work by making their registration in placement services mandatory. Better target the measures to those who may not gain a lot from taking up a job.

- Increase spending on those ALMP whose effectiveness has been demonstrated. Implement the planned data collection and systematic evaluations. Consider testing new programmes with pilot projects before implementation at the national level.

- Allocate more resources to placement services in Public Employment Service (PES). Reorganize PES by creating one-stop shops. Establish an effective online collection of job offers.

Assessment and recommendations

The economy has been resilient

Slovakia has recovered strongly from a deep recession and at a more rapid pace than most other OECD countries. This performance testifies to the ability of the economy, which is highly dependent on exports, to increase productivity growth and achieve wage moderation, thereby regaining international competitiveness. However, GDP growth has remained significantly lower than in the past and underlying imbalances, such as regional labour market disparities, fiscal gaps, and dependence on foreign investors, have become more visible (Figure 1). As in most OECD countries, the 2008-09 crisis and its aftermath generated significant fiscal consolidation needs and debt has increased sharply. Restoring competitiveness supported vital exports. However, weak domestic demand was a drag on economic activity as labour market remains under stress and significant consolidation measures were implemented.

The economy is projected to slow in the wake of the euro crisis and the fiscal consolidation to come. Fewer and smaller new FDI projects are expected while investment in existing foreign-owned companies is likely to be geared towards productivity increases. Weak job creation has reduced the outflow from unemployment, which reached OECD highs and is not set to decline in the absence of policy action, further feeding back into weak domestic demand and job creation.

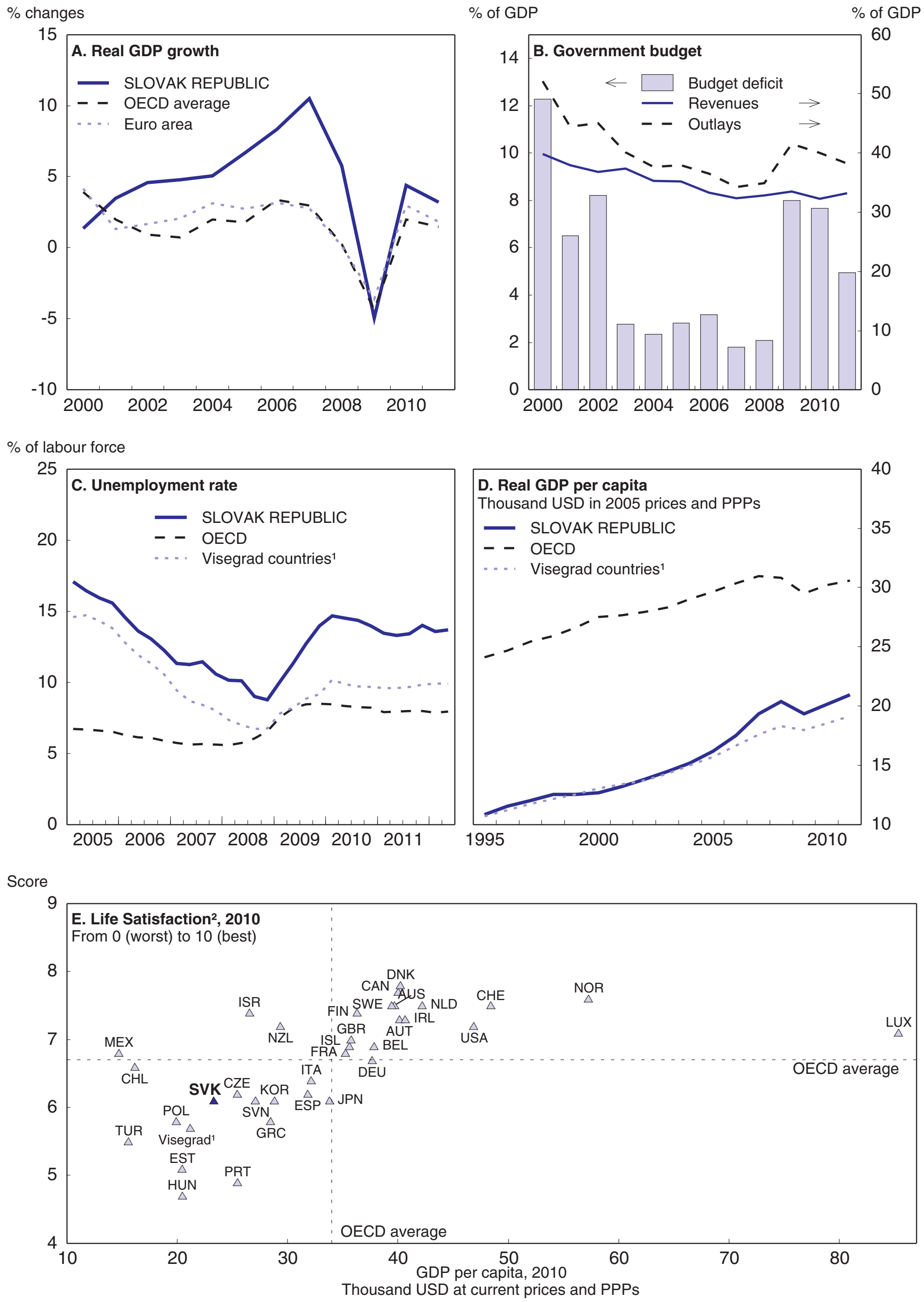
The convergence in GDP per capita relative to the upper half of OECD countries has resumed, but at a slower pace than in the past, not least due to increased unemployment and inactivity. Although Slovakia scores relatively well on aggregate life satisfaction, it ranks below the OECD average on several measures of well–being (including life expectancy and housing conditions) and economic wealth (Figure 1). The priority for policy makers in the fragile international environment is to ensure fiscal sustainability in a growth friendly way, respecting a number of constraints and tradeoffs.

Improving labour market outcomes are a key to successful fiscal consolidation. Reducing unemployment and turning benefit recipients into active members of the labour force is creating the potential for a multiple dividend increasing potential growth, raising revenues from taxes and social security contributions while relieving the budget from social benefits and reducing income inequalities. Reforms should be broad based and include measures on the supply and demand side, as well as addressing matching efficiency. In particular, endowing job seekers with employable skills will require substantial reforms to the education system as well as in activation policies. It is also important to diversify the sources of growth to stimulate job creation.

Efficiency gains in the public sector will contribute to the fiscal consolidation effort. Multi-year expenditures ceilings combined with outcome-oriented budgeting procedures at the central and local level would help to define priorities for public expenditures. Simplifying tax collection and improving the absorption of EU funds would help to both correct fiscal imbalances and spur growth.

Spending cuts and revenue increases will be required to address fiscal consolidation needs. On the spending side, the room for expenditure cuts is limited and they should continue to be avoided in priority areas such as education and active labour market policy measures which are currently underfinanced. On the revenue side, tax increases should focus on the less distortive taxes, such as property, consumption and environmental taxes. In the longer term, reforms to pension and the healthcare systems are needed to address future increases in spending related to the ageing of the population and cost increasing health care innovations (OECD, 2006; Dormont *et al*., 2006; Smith *et al*., 2009).

Figure 1. Key macroeconomic indicators



1. Refers to Czech Republic, Hungary, Poland and Slovak Republic.
2. Life satisfaction is measured by asking people the rate how they value their life in terms of the best possible life (10) through to the worst possible life (0). The score for each country is calculated as the mean value of responses.

Source: OECD *Economic Outlook database* and OECD (2011), *How's Life? Measuring well-being*.

The in-depth structural chapter on green growth of the 2010 Economic Survey of Slovakia has documented the progress made and remaining challenges in this area. The Annex A1 on Progress in structural reform confirms the responsiveness of the Slovak government to implement measures facilitating a transition to greener growth. Nevertheless, despite the significant improvements over the past decade energy and greenhouse gas emissions intensities are still quite high by international standards. Further progress will rely on getting incentives right and providing the adequate price signals, encouraging the use of less emission and energy intensive activities.

With respect to more local environmental issues progress is more uneven. Most air quality standards are respected and air pollution has declined overall, although the prevalence of some pollutants has increased (*e.g.* NO_x from road transport), sometimes exceeding values for protection of human health (*e.g.* ground ozone concentration). Waste management is among the worst in the European Union. Waste processing relies heavily on landfills and incentives for recycling are lacking. The costs of cleaning up contaminated sites have been estimated at 1.8% of GDP (OECD, 2011b). Making the transition to greener growth, a more dynamic domestic source of economic activity, employment and wellbeing will require continuing with the implementation of a broad range of measures, including improving the efficiency of existing environmental policies but also promoting entrepreneurship and innovation. In this respect, recommendations detailed in the in-depth chapter on "green growth" in OECD (2010a) are still valid. In particular, more could be done to unleash eco innovation by better integrating the domestic knowledge base with investors.

The short-term outlook has weakened

While remaining one of the strongest in the euro area, the economy has slowed due to both external and internal factors, which reinforce each other. The weakening of the world economy has weighed on Slovakia's main growth drivers. In particular, the euro area debt crisis has reduced demand from its main trading partners and weakened investor confidence. While exports and investment continued to contribute positively to growth, supported by FDI inflows to existing enterprises, their contribution has weakened. Export and investment growth has normalised after one-off increases mainly due to the opening of new production lines in the automotive sector in 2011 and beginning of 2012. Domestic demand has remained weak reflecting the high unemployment rate and significant fiscal consolidation. Firms seem to have adjusted employment and remuneration to remain competitive. As a consequence, the recovery in the labour market has slowed, employment remains below pre-crisis levels, and real wage growth has come to a standstill. Precautionary saving increased on the back of deteriorated consumer confidence. The increase in the VAT rate as well as the wage cuts in the public sector and temporarily higher inflation also contributed to lowering household real disposable income. The brisk turnaround of real appreciation and terms-of-trade gains weighs on domestic demand and reinforces private and public deleveraging needs.

Growth is set to gradually pick-up in the coming years (Table 1). Exports will likely remain the main drivers of growth on the back of stronger world trade, although the outlook for Slovakia's main export markets (especially Germany) is uncertain. Export oriented companies are under pressure to improve competitiveness and invest in order to increase productivity rather than to create new jobs. It is likely that further efforts to restore competitiveness will be necessary. Thus, labour market outcomes are expected to improve only slowly, with the unemployment rate decreasing to 13% by 2014. Given the outlook for high unemployment and low wage increases inflation is set to decline close to 2.5% in 2013 and 2014. The new government is sticking to its plan of reducing the deficit to below 3% of GDP by 2013 and to 2.4% in 2014 from 4.6% in 2012. This will require a significant consolidation effort, which the government intends to achieve mainly by revenue increases, but also by a reduction of the size of the second pension pillar. As a consequence, domestic demand is set to resume only slowly.

Table 1. Short-term projections

	2010	2011	2012	2013	2014
	Percentage changes, volume (2005 prices)				
GDP at market prices	4.4	3.2	2.6	2.0	3.4
Private consumption	-0.7	-0.5	-0.1	0.8	1.4
Government consumption	1.0	-4.3	-0.6	0.2	0.7
Gross fixed capital formation	6.5	14.2	0.5	0.6	2.5
Final domestic demand	1.0	1.9	0.0	0.6	1.5
Stockbuilding[1]	2.5	-0.7	0.0	-0.1	0.0
Total domestic demand	3.8	1.1	0.0	0.5	1.5
Exports of goods and services	16.0	12.7	8.8	4.7	6.7
Imports of goods and services	14.9	10.1	6.3	3.7	4.9
Net exports[1]	0.7	2.0	2.3	1.0	1.9
Memorandum items					
GDP deflator	0.5	1.6	1.8	1.4	1.6
Harmonised index of consumer prices	0.7	4.1	3.7	2.5	2.4
Private consumption deflator	1.0	3.8	3.6	2.5	2.4
Unemployment rate	14.4	13.5	13.7	13.6	13.0
General government financial balance[2]	-7.7	-4.9	-4.6	-2.9	-2.4
General government gross debt[2]	45.9	48.0	57.0	59.7	60.9
General government debt, (Maastricht)[2]	41.0	43.3	52.2	54.9	56.2
Current account balance[2]	-3.7	-2.1	1.7	1.8	3.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. See *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods)*.

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

2. As a percentage of GDP.

Source: OECD Economic Outlook 92 database.

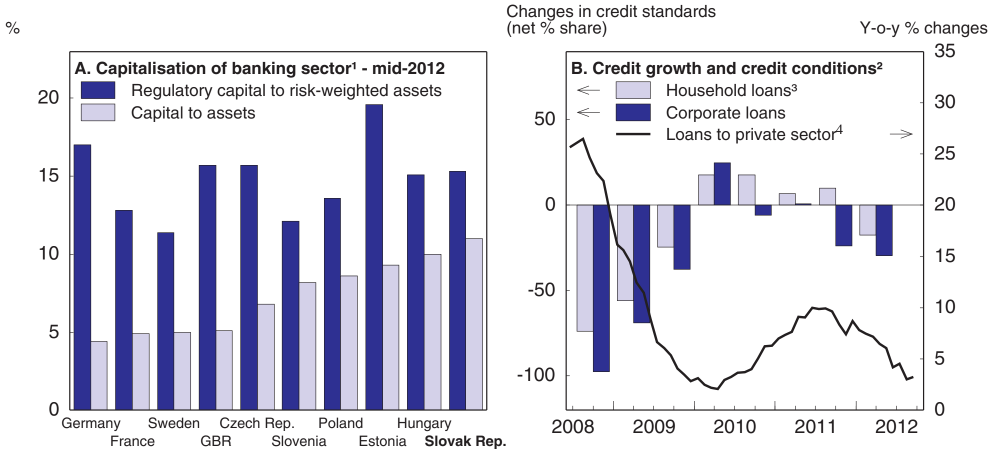
These projections, which assume a gradual improvement of the international environment, in particular a smooth resolution of the euro area debt crisis, are surrounded by considerable uncertainty. Trade developments are the main risk for growth, as the Slovak economy relies mainly on external demand. At the same time, a positive current account reduces the dependence on external financial sources. Nevertheless, a repetition of the 2009 collapse of world trade would again have serious consequences for Slovakia, affecting both exports and also FDI inflows. The room for productivity increases and wage moderation to restore competitiveness will be crucial in determining future developments of investment (FDI in particular) and employment, the risk being a relocation of production to cheaper locations. However, a success of recent euro crisis resolution measures could lead to a more rapid recovery of investor sentiment and in this case Slovakia would again benefit as a location for foreign direct investment.

Domestic demand is another risk to the projection. A successful fiscal consolidation would strengthen confidence and thus stimulate domestic demand. The household saving ratio has been increasing to historical highs during the crisis and could be reduced if consumer confidence improves. A credible fiscal consolidation could also lower financing costs and reinsure investors. By contrast, the size of the fiscal multipliers may be higher than projected in particular if the economic environment deteriorates further. Overall, downside risks are predominant.

The euro debt crisis could also weaken the foreign-owned banking sector but the risks remain contained. Ownership is dominated by groups located in euro area countries with long-term strategic interests in the region. A deterioration of the euro area crisis could spillover by increasing spreads on Slovak government bond, which are mainly held by the Slovak banking sector. Also, it could significantly raise the share of non-performing loans and lead to liquidity withdrawal by parent banks (IMF, 2012). At the same time, with a loan to deposit ratio at around 90%, the banking sector does not rely on foreign funding.

This should continue as long as the currently low demand for loans prevails. The banking sector appears to be well capitalised with a Tier 1 ratio at 14% in June 2012 (Figure 2). The share of non-performing loans in total loans is relatively low (5.4%) and falling. In addition, the National Bank has enacted regulatory measures on top of what is foreseen under the Basel III framework to enhance banking sector stability. This includes notably restrictions on dividend distribution depending on the level of core Tier 1 ratio to protect the capital buffer from being eroded by dividend payments. Cross border cooperation among supervisors has strengthened and credible medium to long-term business strategies of the respective mother banks make it likely that future capitalisation needs will be met in a way which reduces the risk of a credit crunch. However, as long as the euro crisis is not resolved, contagion risks will impose a premium on access to wholesale financing.

Figure 2. Capitalisation of the banking sector and credit conditions



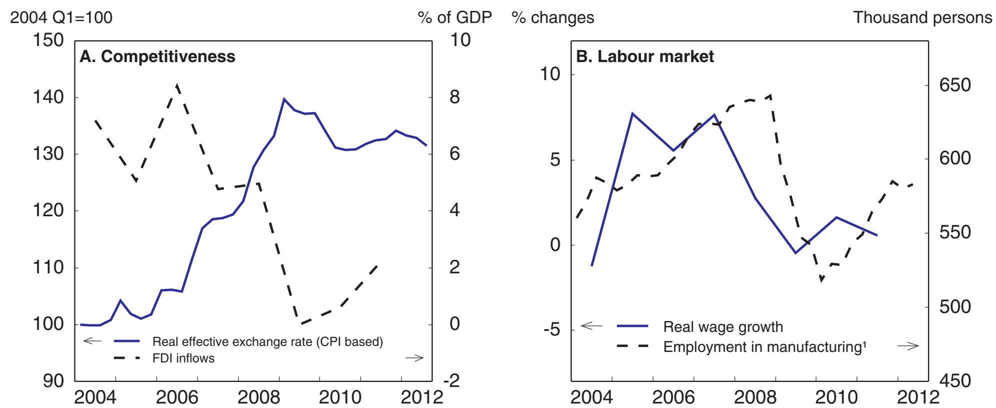
1. Capital is balance sheet equity (paid-in capital plus reserves). For France as of mid-2011; for the United Kingdom as of end-2011; for Estonia and Sweden as of first quarter 2012.
2. The Eurosystem has developed a survey of bank lending in the Euro area to enhance the Eurosystem's knowledge of financing conditions. The survey addresses issues such as credit standards for approving loans as well as credit terms and conditions applied to enterprises and households. Data presented here show actual changes in bank credit standard in the given 6 months. They are expressed in net percentage share of banks that eased their credit standards calculated as the difference between the percentage market share of banks, which reported easing of their credit standards, and the percentage market share of banks, which reported tightening of their credit standards.
3. Unweighted average of net percentage shares on household loans for house purchase and household loans for consumer credit.
4. Covering both non-financial corporation loans and loans to household and non-profit institutions, in growth rates.

Source: IMF, *Financial Soundness Indicators database; European Central Bank, Statistical Data Warehouse*; National Bank of Slovakia, "Survey on Supply and Demand on Lending Market".

Medium and long-term economic prospects are uncertain

The Slovak Republic's main economic challenges are twofold. In the medium-run it is to maintain the productivity and competitiveness of its economy, particularly in relation to neighbouring economies where labour costs are lower. Before 2009, economic growth was driven by a strong inflow of FDI in export oriented manufacturing, in particular in automotive sectors and consumer electronics (flat screens). Since the crisis, the inflow of large, wage-cost sensitive and job-creating FDI projects has come to a standstill and price competitiveness has deteriorated somewhat (Figure 3, left panel). As a member of the euro area, the country has been fully exposed to the foreign trade shock without the possibility to adjust its nominal exchange rate, whereas neighbouring countries experienced depreciations. Competitiveness is now being sustained through reductions of wage costs (Figure 3, right panel). Weak growth and low wage increases are projected to lead to disinflation and to increase the real interest rate and borrowing costs. This may undermine domestic investment and thus the desirable diversification of growth drivers. Slovakia's dependence on assembly (notably of cars and electronics) has advantages, but also poses risks from over specialisation. The challenge is therefore to develop dynamic domestic drivers of growth. This requires improving further business environment notably by removing remaining administrative barriers to entrepreneurship and eliminating corruption as recommended in the previous *Economic Survey* (OECD, 2010a).

Figure 3. Competitiveness and labour market developments



1. Prior 2008, data were collected according to NACE Rev 1.1. A correction coefficient is applied to be consistent with current NACE Rev 2 data in manufacturing.

Source: *OECD Economic Outlook database* and Statistical Office of the Slovak Republic.

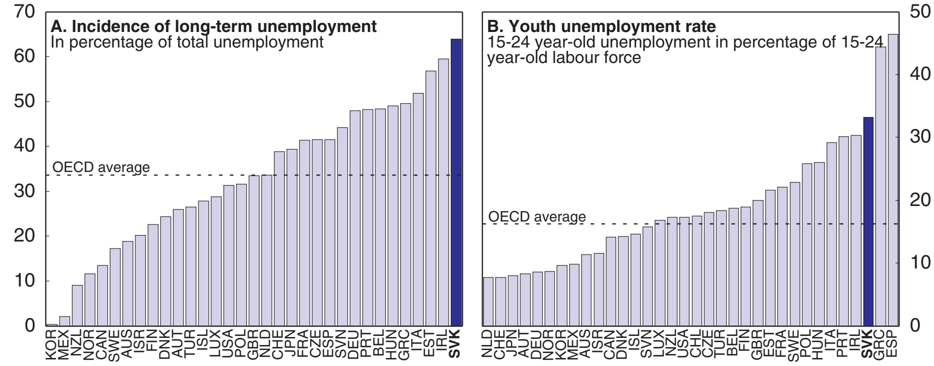
In the longer run, population ageing will weigh on growth, increasing the benefits from activating parts of the working age population currently not participating in the labour market and tackling the unsatisfactory transition from school to work. The state of the knowledge economy remains rather backward and not well integrated with the economy, not only compared to the most advanced OECD countries. The levels of innovative firms and scientific publications are relatively low (OECD, 2012c). Improvements in the knowledge economy will be needed to converge towards best performing OECD countries, both in terms of growth and welfare, and to make the transition towards a greener economy. Currently the economy is specialized in energy-intensive production (OECD, 2010a). Adopting green technologies and building capacities for eco-innovation (*i.e.* the implementation of innovative products, processes, marketing methods, organisational structures which lead to environmental improvements) could facilitate the transition, but requires the right incentives and new skills. It could foster the development of new sectors and could create a new comparative advantage for Slovakia as argued in the green growth chapter of the last *Survey* (OECD, 2010a). For instance, innovations aiming at improving energy efficiency would reduce the dependency on imported fossil fuels, the vulnerability of the economy to energy price shocks and the cost of climate change mitigation.

Labour market developments have been unfavourable

Employment has not yet returned to its pre-crisis level as firms attempt to restore competitiveness losses stemming from nominal appreciations before the crisis, as well as depreciations of currencies of neighbouring peers during the crisis. The unemployment rate rose significantly during the crisis and is now the fifth highest among OECD countries at 13.8%. Long-term and youth unemployment rates are particularly high by OECD standards (Figure 4). The incidence of long-term unemployment was twice the OECD average and the youth unemployment rate was the third highest in the OECD in 2011. The share of low educated workers in total unemployment amounts to around 60% and the skills mismatch has been aggravated. The Roma population is *de facto* excluded from the labour market with an unemployment rate above 70% (UNDP, 2012). Labour market outcomes are set to remain poor, foreshadowing a further rise in structural unemployment, imposing a lower potential output and higher costs of fiscal consolidation.

Figure 4. Labour market outcomes

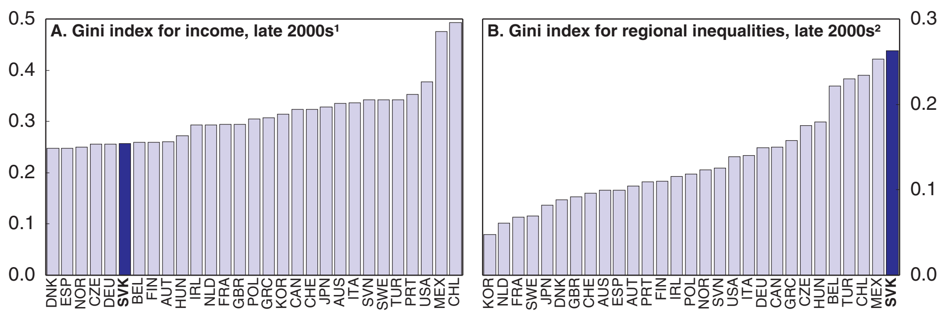
In 2011



Source: OECD, *Labour Force Statistics database*.

Beyond the impact of unemployment on growth and wealth, poor labour market performance may also increase inequalities. While inequalities are low in Slovakia compared to the OECD average – the dispersion of wage and household income is among the lowest in the OECD – regional disparities are large because of a concentration of poor households in Eastern regions and high income earners in the Bratislava region (Figure 5). Following the recent increase in long-term unemployment in deprived regions and because of low labour mobility, hysteresis effects may deepen geographical inequalities by excluding a large share of the local population from the labour market. The rate of people at risk of poverty or exclusion - measured by Eurostat as the rate of people at risk of poverty, or severely materially deprived or living in a household with very low work intensity - fell by 11 percentage points from 32% in 2005 to 21% in 2010, because of past falls in unemployment. This trend may reverse with the deterioration of the labour market outcomes if the fading foreign drivers of job creation cannot be replaced and if labour market policies to activate the unemployed are not implemented more forcefully.

Figure 5. Inequalities



1. Gini index of inequality of household disposable income, after taxes and transfers. The values of the Gini coefficient range between 0, in the case of "perfect equality" and 1, in the case of "perfect inequality".
2. Gini index of inequality of GDP per capita across TL2 regions. As above, the values of the Gini coefficient range between 0, in the case of "perfect equality" and 1, in the case of "perfect inequality".

Source: *OECD Regional Outlook 2011* and OECD, *Income distribution and poverty database*.

Consolidating public finances in a growth-friendly way

Fiscal consolidation is needed in view of the consequences of high budget deficits for the path of liabilities. The fiscal deficit and debt have increased sharply during the crisis (Figure 6, left panel, Table 2). While the budget balance improved significantly in 2011, in absence of further policy action, general government debt dynamics would continue to increase rapidly. According to recent OECD estimates, stabilizing debt at 50% of GDP in 2050 would require improving the underlying primary balance by 3% to 5% of GDP, on top of the current consolidation efforts, from 2012 onwards depending on assumptions on the future increases in pension and healthcare spending. New challenges, such as higher unemployment and population ageing, add to inherited spending pressures, stemming from distorted incentives in favour of cost-increasing health care innovations. There is thus no alternative to continued fiscal consolidation, especially given the risks surrounding public borrowing costs. Moreover, the spread of Slovak government bonds over German reference bonds increased to more than 300 basis points by mid-2012 (from around 100 basis points at the beginning of 2011), the sixth highest absolute rise in the euro area (Figure 6, right panel). In the meantime spreads have fallen again, but remain sensitive to changes in the assessment of the ability to meet fiscal targets.

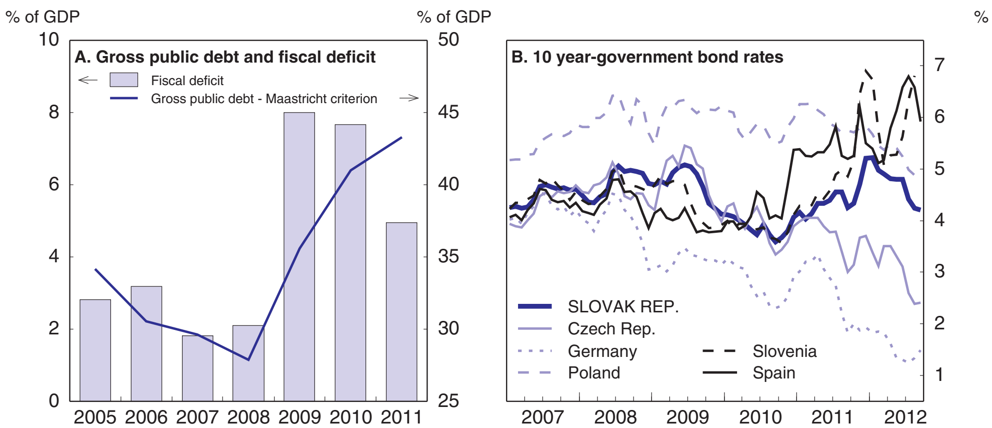
Table 2. Public finances

		2005	2007	2008	2009	2010	2011
Government deficit	SVK	-2.8	-1.8	-2.1	-8.0	-7.7	-4.9
	OECD	-2.4	-1.3	-3.4	-8.2	-7.7	-6.5
	Euro area 15	-2.6	-0.7	-2.1	-6.3	-6.2	-4.1
Gross public debt	SVK	37.4	33.5	32.2	40.4	45.9	48.0
	OECD	77.9	74.2	80.7	92.2	98.7	102.9
	Euro area 15	78.2	71.9	77.1	87.8	93.1	95.2
Government total receipts	SVK	35.2	32.4	32.8	33.5	32.3	33.2
	OECD	36.9	37.8	37.6	36.4	36.3	36.7
	Euro area 15	44.8	45.3	45.1	44.9	44.8	45.4
Government total disbursements	SVK	38.0	34.2	34.9	41.5	40.0	38.2
	OECD	39.3	39.1	41.0	44.5	44.0	43.2
	Euro area 15	47.4	46.0	47.2	51.3	51.0	49.5
Net government interest payments	SVK	1.1	1.0	0.9	1.1	1.2	1.4
	OECD	1.7	1.6	1.6	1.5	1.6	1.8
	Euro area 15	2.7	2.6	2.6	2.5	2.5	2.6

Source: OECD, *Economic Outlook Database*.

Delaying consolidation for too long may have adverse effects on growth, in particular because of higher risks premiums (Padoan *et al.*, 2012). Financial markets have become more prone in abrupt changes in confidence. Under current circumstances the uncertainty is so high that a temporary cyclical worsening of fiscal accounts would be interpreted as a structural inability to control public debt. Therefore, fiscal consolidation plans to reach the below 3% of GDP deficit target in 2013 and comply with the EU requirements should be implemented. In addition, fiscal policies should be coupled with structural reforms which increase the growth potential of the economy. Effective prioritisation of government expenditure programmes in this respect will be important.

Figure 6. Fiscal deficit and 10-year government bond rates



Source: *OECD Economic Outlook database.*

Improving the fiscal framework

Strengthening the medium-term budgetary framework

To limit the risks of slippage from the long-run adjustment path, the medium-term budgetary framework needs to be strengthened. In the past, structural deficit problems have arisen from a failure to reduce deficits enough during boom years, associated with a tendency to use supplementary budgets to spend short-term revenue windfalls. The government introduced new rules to strengthen fiscal discipline in 2011.

An upper limit of 60% of GDP has been set on general government debt until 2017, with graduated sanctions being phased in when the debt level exceeds 50% of GDP. Starting 2018 the debt bracket will be cut by 1 percentage point annually, until it reaches the final ceiling of 50% of GDP in 2028. In addition, in March 2012 Slovakia was among the 25 EU-signatories to the *Fiscal Compact*, which introduces stricter fiscal surveillance, notably by establishing a balanced structural budget rule that must be transposed into national legislation within one year after the ratification of the treaty. The national fiscal rules would then need to be made consistent with the EU fiscal discipline requirements. These requirements lead to a trend decline of government debt, while the Slovak rule at the moment foresees corrective action only if the debt level exceeds the threshold. In the long run, the structural balance rule will also be more binding than the debt ceiling. A way out could be to introduce spending ceilings consistent with reaching a structural balance in the medium term in national legislation.

A Fiscal Responsibility Board has been set up notably to monitor and evaluate compliance with fiscal rules. In particular, it will assess whether the short- and long-run sustainability criteria are being met and advice on the budget adjustment needed to achieve them if they are not. The creation of an independent body to monitor government policy is an important advance in the pursuit of budget transparency.

Improving budgeting procedures

Reforms of the budgeting procedures can facilitate consolidation and ensure long-term sustainability of public finances. It could help to prioritize public spending more effectively to maximise its growth enhancing potential. Main elements include the following items:

- An increasing focus on multi-year budget planning has been implemented, but targets for the out years have been indicative and subject to *ad hoc* change. More effective budget planning is thus needed to ensure that the consolidation process is successful. Expenditure ceilings should be introduced as planned.

- High-level budgetary allocations are made centrally and reflect political priorities, but budgets need to be implemented flexibly to ensure efficiency and service quality, based on results. More freedom should be given to ministries in using funds, for instance by enhancing some degree of end-of-year flexibility. This managerial flexibility should be conditioned to the further development of monitoring and accountability.

- Appropriate performance and results information should be included in the annual budget documentation. While Slovakia has clearly achieved a higher standard of fiscal reporting and transparency, there is room for further improvement. Slovakia ranks poorly in the "Open Budget Index 2010" regarding the provision of satisfactory information on public finances and stands behind the Czech Republic and Poland (International Budget Partnership, 2010). Also, budget allocation is not linked closely to programme monitoring and evaluation, and administration capacities are too weak to ensure follow-up assessments. Finally, despite some progress, corruption remains an issue. The public administration needs to make better use of results-oriented budgeting, including improved ex post audit processes, enhanced transparency and greater public oversight. The government plans to appoint analysts in each Ministry to assess the efficiency of policies. While this is highly welcome, the use of performance elements in financing, contract renewals and compensation could also be widened.

Ensuring the sustainability of the pension system

With the rapid ageing of the population, reforming the public pension system will be necessary to ensure its long-term sustainability. By 2060, Slovakia will have had the steepest increase in the old-age dependency ratio of all EU member states and will rank second after Poland in its level. Under current policies, pension expenditures are projected to increase by 5.2% of GDP by 2060, compared with an average increase of 1.5% of GDP in the EU27 (European Commission, 2012). Recent reforms to delay retirement age and modify the indexation of pension, in line with recommendations from the last *Survey* (OECD, 2010a), are thus welcome. The retirement age will be gradually increased in line with gains in life expectancy and pension growth will be progressively linked to the inflation rate of a retiree consumption basket. These measures may nevertheless not be sufficient to ensure the sustainability of the first pillar in the face of likely future increases of life expectancy. Consideration should be given to adapting the replacement rate to the financing conditions, for instance by including a sustainability factor into the pension formula to ensure a cut-back of replacement rates as the old-age dependency ratio worsens as in place in several countries like Sweden, Germany or Austria and as recommended in the last *Survey* (OECD, 2010a). In doing so, care needs to be taken to avoid undermining old age poverty alleviation.

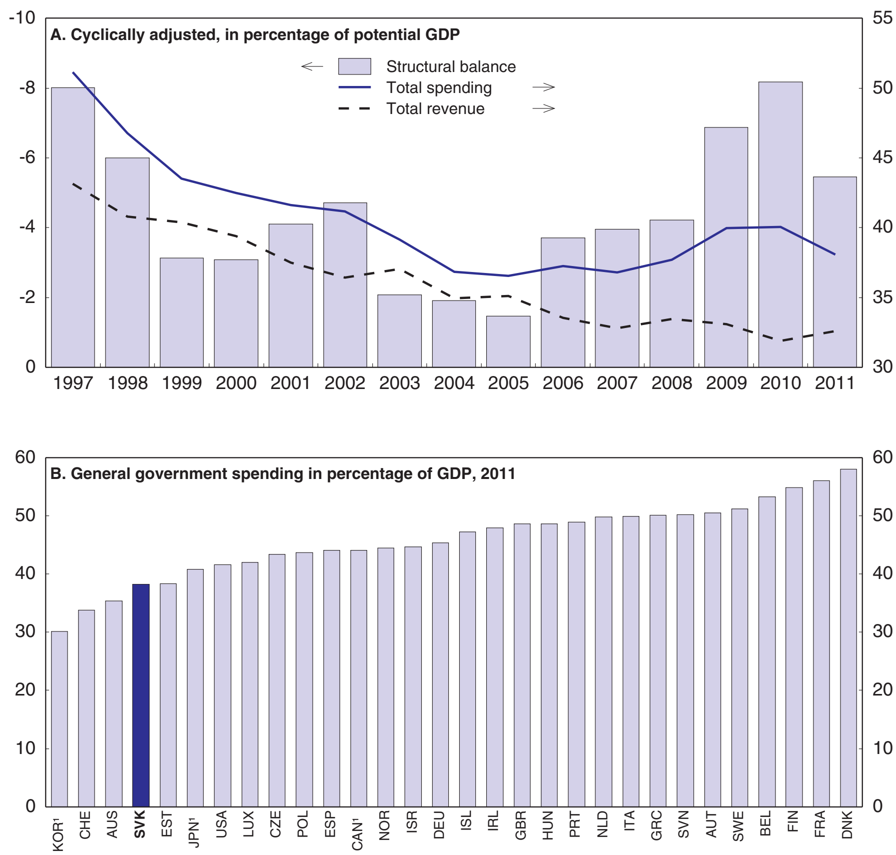
The redistributive effect of the current pension system is weak by OECD standards. Recent reforms make the pension system more progressive. The temporary increase in pensions by a fixed amount is aiming at increasing solidarity for existing pensions. Also, in line with recommendations from previous *Surveys* (OECD, 2009; 2010a), the link between earnings and subsequent pensions will be weakened for new pensioners directly in the pension formula. These reforms are welcome as they reduce the risk of poverty traps for pensioners who do not accumulate entitlements beyond the poverty level. The reforms will have to be accompanied by measures ensuring that it is always more advantageous to work than to stay inactive.

The contribution rate to the second pillar has been reduced from 9% to 4% as part of its consolidation strategy. The contribution rate will start to increase in 2017 by 0.25% each year until it reaches the target level of 6% in 2024. In the currently exceptional situation a temporary reduction of contributions to the second pillar may help to avoid otherwise necessary pro-cyclical fiscal consolidation measures. However, weakening the second pillar may undermine the sustainability of the pension system if it directly or indirectly increases future liabilities of the first pillar. Also, this reform may damage the old age security system in the long run. Second pillar pensions can make old-age income replacement systems more robust, because they widen sources from which incomes will be drawn (OECD, 2010a). This is crucial in Slovakia as the generosity of the fist pillar will be reduced by the reforms required to ensure its long-run sustainability. Evaluating the sustainability of the pension system as a whole, assessing the impact of recent reforms on the old age security system and determining the optimal size of the second pillar is urgently needed. Finally, Slovakia exhibits an extraordinary degree of system changes and reform reversals, inducing potentially large inefficiencies. One of the crucial design features of second pillar systems is the stability of the regulatory framework, without which any investment strategy can become overly short-term and may suffer from restrictions on the ability to pursue profitable investment strategies. Frequent design changes in the pension system should be avoided.

Reducing the cost of consolidation

Given consolidation needs, corrections to both revenue and expenditure paths are parts of the consolidation strategy. Total receipts and spending per unit of GDP declined over the past decades, not least due to strong economic growth (Figure 7). Public spending is low by international comparison and the room to further reduce it is tight. Slovakia, as a catching-up economy with a low level of public spending, may need to increase investment in growth-enhancing areas. In addition, past consolidation measures included already significant expenditure cuts (55% of the consolidation effort). Nevertheless, potential efficiency gains in the public sector should be achieved. In this respect, increasing efficiency in the drawing of EU funds as well as in the healthcare sector would be particularly helpful. By contrast, a further decline in tax revenues is unlikely to be sustainable. Tax increases should focus on taxes which are less damaging for growth and for labour market outcomes in particular such as real estate, environmental or consumption taxes (OECD, 2010e). Tax expenditures should be removed in order to improve resource allocation.

Figure 7. General government spending and revenue



1. Refers to 2010.

Source: OECD Economic Outlook 91 database.

Refining the planned consolidation measures

In 2013, reducing the deficit to below 3% of GDP will require a consolidation effort of around 3% of GDP. The preliminary budget for 2013-2015 already included measures amounting to 0.7% GDP (*e.g.* the freeze of public wages and expenditure in goods, services and capital). The government has decided to save additional 3% of GDP: a reserve amounting to 0.7% of GDP will be created to finance a possible shortfall of revenues. In case of sufficient revenues this amount could be used for priority spending. The opportunity cost of these new expenditures may be high, requiring a high rate of return on investment financed by it. Thus, the effectiveness of the additional spending should be carefully assessed before being implemented.

After significant spending cuts in the previous consolidation package, the government's planned consolidation will mainly rely on tax increases (Table 3). The consolidation effort will be sizeable and will weigh on growth, but some refinements of the planned measures would limit potentially adverse effects.

- The contribution rate to the first pillar will be increased from 9% to 14% and the contribution rate to the second pillar reduced from 9% to 4%. This measure is likely to have no impact on domestic demand and will bring in around 1% of GDP for the budget.

- The partial harmonization of taxation of self-employed and standard labour contracts is highly welcome. Self-employed workers currently benefit from a lower tax wedge, as their tax base for social security contributions is only half of the average monthly taxable income of the previous year. This encourages involuntary self-employment as firms may try to evade social security contributions by substituting regular employees with self-employed (OECD, 2010a).

- The formerly flat income tax will be made progressive. The tax rate will increase from 19% to 25% for a monthly income above EUR 3 311 in 2013. More importantly the maximum assessment base for social security contributions will be increased from one and half, three and four to five times the average wage. These measures will increase redistribution in the tax system from its currently relatively low level (Joumard *et al.*, 2012) and better split the consolidation effort among citizens according to their capacity to pay. However, for specific groups (in particular earning between 4 to 5 times the average wage), these measures will induce a large increase in marginal tax rate. It would be advisable to explore how this increase could be smoothed.

- The tax burden on business will be increased. The corporate income tax will be increased from 19% to 23% (which remains below the tax rate in most OECD countries). At the same time, the tax base of the bank levy introduced in 2012 will be broadened to household deposits and temporary extra taxes will be levied on profits in regulated sectors (energy, telecommunication, insurance, postal services) in 2013.

Table 3. Consolidation measures as planned in November 2012

% of GDP	2013	2014	2015
Expenditures	**1.2**	**1.4**	**1.9**
Cuts in wage bill and consumption of central government	0.4	0.6	0.7
Revenues	**2.4**	**1.9**	**1.9**
Direct taxes	0.9	1.0	1.0
Pension system (soc. sec. contrib. first pillar)	1.0	0.7	0.7
Bank levy	0.1	0.1	0.0
Levy on regulated sectors	0.1	0.0	0.0
Indirect taxes (tobacco, gambling, vehicles)	0.2	0.2	0.1
Reserves	**-0.7**	**-0.4**	**-0.5**
Total	**3.0**	**3.0**	**3.3**

Source: Ministry of Finance.

Alternative tax measures less harmful to growth exist. A new real estate tax based on the market value of property was considered but not included in the 2013 budget proposal. This measure in line with OECD recommendations (OECD, 2010a) should be implemented swiftly. Slovakia has fairly low tax receipts from property of around 1% of total tax revenues, a quarter of the OECD average (Table 4). Increasing property taxes to the OECD average would raise government revenues by 0.6% of GDP. It would also reduce a tax distortion. The current taxation of real estate is below the level of taxes on investment in financial assets and is not based on market values, thereby distorting the allocation of capital towards owner occupied housing and amplifying the volatility of house prices.

The government should also consider developing the taxation of environmentally harmful activities, which could contribute to fiscal consolidation while supporting green growth. The introduction in 2013 of a car registration fee on personal cars is a step in the right direction. Reducing further exemptions and reduced tax rates on energy consumption would increase tax revenues by 0.1% of GDP, discourage wasteful consumption and encourage the adoption of energy-saving technologies and clean energy sources. The creation of a carbon tax in the sectors not covered by the EU-ETS would improve the pricing of negative externalities generated by CO_2 emissions and reduce the cost of climate change mitigation in Slovakia (OECD, 2010a). However, the redistributive impact of such measures should be carefully assessed and actions should be envisaged to compensate possible negative social effects.

Table 4. Composition of tax revenues

% of total tax revenue, 2009

	Slovakia	**OECD**
Labour taxes	52	52
Personal income tax	8	25
Social security contributions	44	27
Taxes on goods and services	36	33
Corporate income tax	9	8
Taxes on property	1	5
Recurrent taxes on immovable property	1	3

Note: Social security contributions include those paid by the self-employed and benefit recipients.

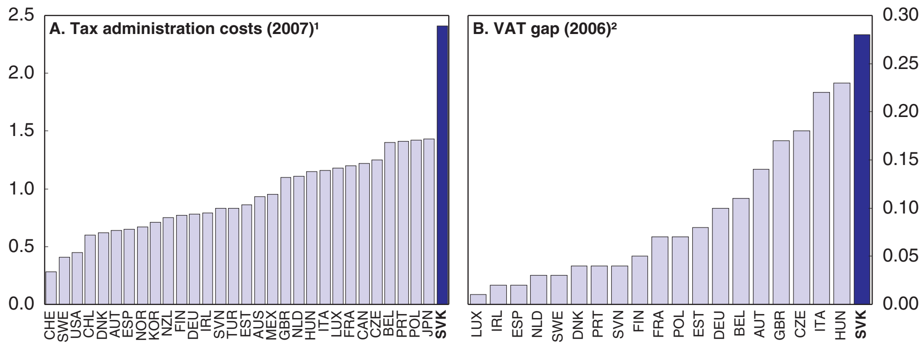
Source: OECD (2011d), *Revenue Statistics*.

Improving the collection of taxes

Efficiency gains in the tax system would contribute to improving the fiscal situation while stimulating productivity gains both in the public sector and in the private sector. Tax collection is particularly inefficient in Slovakia, suggesting that reforms of tax administration may lead to substantial benefits. The administrative cost of tax collection, which compares annual administration costs with the total revenue collected, is the highest in the OECD (Figure 8). Paying taxes is still more difficult in Slovakia than in most of other OECD countries (World Bank, 2011). The reasons for the poor performance of the tax system seem to lie in both low tax compliance and high collection costs. The planned transition towards an integrated tax collection system (UNITAS I and II projects, unifying the collection of taxes and social security contribution) is welcome as it could generate significant synergies, reducing administrative costs for both taxpayers and the administration and could facilitate the control of undeclared work, tax evasion and fraud through better crosschecking and auditing (Leibfritz, 2011). These reforms should be implemented swiftly and monitored.

While exemptions or reduced VAT rates are not widespread and the standard VAT tax rate is close to the European average, actual VAT revenues fall significantly short of what a standard rate would produce (as measured by the VAT gap, Figure 8). Decreasing the VAT gap to the EU average would raise extra revenues by more than 1% of GDP (OECD, 2010a). Combating tax evasion, which is likely to be an important reason for low VAT revenue collection efficiency, should represent an important part of the effort to make the system more efficient and monitoring activities should be strengthened. However, the scope for increasing VAT collection efficiency may be limited in certain regions because of cross border shopping. The reasons for a striking regional concentration of an excessive VAT gap (also significant in Austria and its neighbours) should be explored and countered with an EU-led cross-border task force.

Figure 8. Efficiency of tax collection



1. Ratio of aggregate tax administration costs per 100 units of net revenue collection.
2. The VAT gap is defined as the difference between the accrued VAT receipts and the theoretical receipts, as a share of the latter.

Source: OECD, *Government at a Glance 2011* and Reckon (2009), *Study to quantify and analyse the VAT gap in the EU25 Member States*.

Raising transparency and efficiency of public procurement

The Slovak Republic spends a larger share of total public spending on procurement than the EU average (29% vs. 22% on average in the EU-27). Greater transparency in public procurement is important for cost reduction, not least because it would reduce the risk of fraud, corruption and mismanagement of public funds. Progress has been made in this direction. However, Slovakia does not publish the justification for contract awards and does not allow tracking of public procurement spending online. Furthermore, procurement rules tend to hamper contracting authorities from choosing the most economically advantageous tender because they restrict the choice in evaluation criteria and often forbid qualitative criteria on the grounds that they are discriminatory (OPKE, 2011). The Public Procurement Act should be amended to ensure that the tender achieving the best value for money, meaning the optimal combination of quality and cost, is selected.

In some areas current procurement rules are perceived to be too difficult to apply. Administrative barriers cause large time delays and undermine the provision of public services. As a consequence, efficiency gains from outsourcing cannot be reaped, or government services are provided in a less targeted form than necessary. Difficulties of this nature should be analysed and a task force implemented to provide recommendations on making procurement rules easier to apply, but without undermining the objectives of fighting corruption and increasing efficiency.

Increasing absorption of EU funds

Fully exploiting available sources of funding, notably EU funds, could help to cushion the expenditures cuts induced by fiscal consolidation. It is thus unfortunate that Slovakia is among the countries with the lowest rate of absorption of EU funds (KPMG, 2011). For the implementation period 2007-13, the available budget amounts to close to 3% of GDP per year, including co-financing from the state budget (around 10% of the total) but less than 25% of funds has been used by end 2011. One of the main reason behind the low absorption of EU funds is that the selection process of projects is burdensome and not transparent (OECD, 2010a). As a consequence, stakeholders have only limited access to these funding opportunities. A partnership between the European Commission and the Slovak authorities has been established to discuss and monitor the reasons behind the low absorption of EU funds. The system for EU funds' management should be reformed based on this analysis. In particular, the administrative hurdles to the submission of projects should be reduced.

Improving cost-efficiency in the healthcare sector

The healthcare sector is a key area for the fiscal consolidation strategy. Healthcare spending accounted for 16% of public expenditures in 2010 and rapid population ageing will add to spending pressures. Efficiency in the healthcare sector is low by international standards (OECD, 2010a). As a result, the adoption of "best practices" may yield large productivity increases. According to OECD estimates, Slovakia could achieve the same health outcomes with cost savings of around 2% of GDP in 2060 (Joumard *et al*., 2010).

A number of measures to reduce such costs have been implemented recently, in line with OECD recommendations. Since 2011, the prescription of generics has been made mandatory for certain types of drugs. Health parameters have been introduced in the risk-equalisation formula for insurance companies. The decision to start implementing a system of diagnosis related groups (DRG) to standardise payments for healthcare procedures and reduce hospital costs is welcome. Further reforms should be considered, such as extending mandatory generic prescription.

The government has announced that it does not want to continue with the recommended transformation of hospitals into joint stock companies. It will therefore be important to search for other ways to improve incentives for cost-effective hospital management. Strengthening the capacity of the public administration to monitor, assess and evaluate health care spending programmes and institutions is therefore becoming even more important (see above).

Slovakia is using a multi-company model for health care insurance. The focus of policy in this case should be to increase competition between health-care providers as well as health insurers and also ensure transparency through better public information on costs and quality. In this regard, extending the collection of quality indicators is thus desirable (OECD, 2010a). Consideration is currently being given to merge and nationalize healthcare insurance providers. This option is acceptable *per se* as evidence tends to show that such a model is not sub-optimal compared to a multi-company model (Joumard *et al*., 2010). However, as for the pension system, frequent changes should be avoided in the healthcare system unless they are supported by cost and benefits analysis.

Box 1. Key recommendations for fiscal policy

- Further strengthen the medium-term spending framework by introducing spending ceilings as planned, and adhere to them.
- Increase the scope for monitoring and evaluation of spending programmes. Widen the use of performance elements in financing, contract renewals and compensation.
- Continue efforts to improve tax collection by implementing the transition towards an integrated tax collection system. Further combat tax evasion by strengthening monitoring activities.
- Reform the structure of taxation to make it less harmful to growth notably by increasing real estate and environmental taxes and lowering labour taxes paid by employers at lower wage levels to encourage greater labour demand.

Reforms to underpin longer-term growth

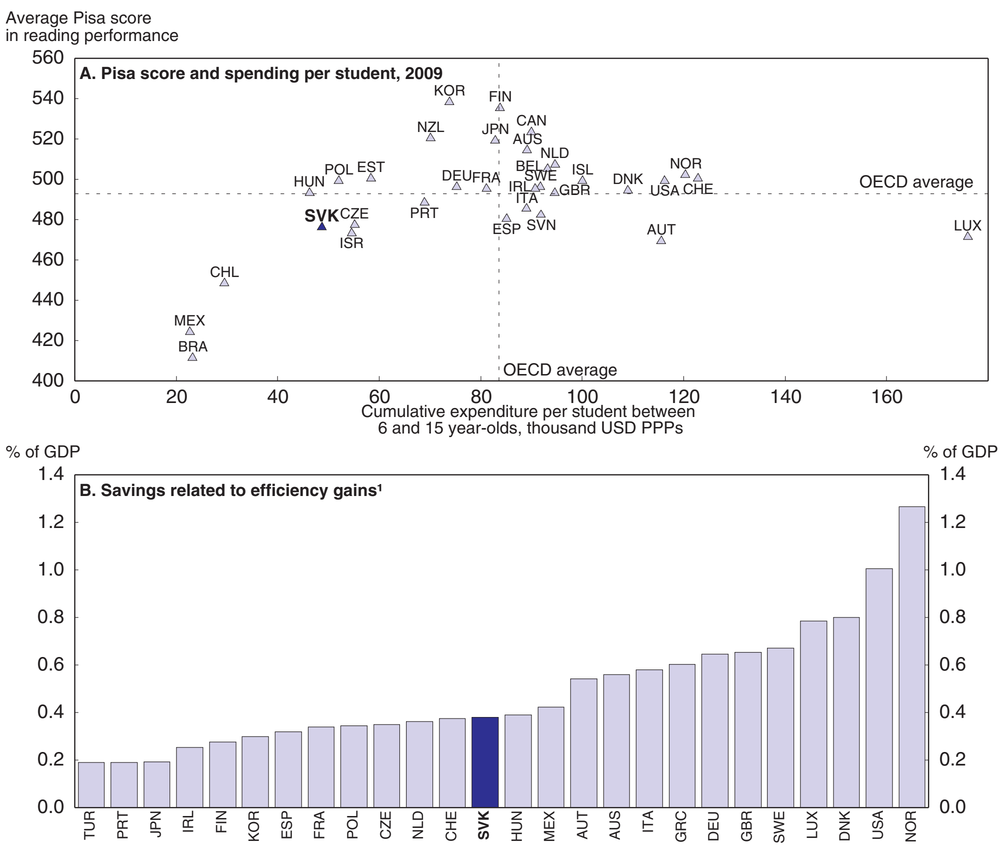
Slovak educational and labour market outcomes are weak by international standards. Improving performance in these two areas is a priority task. Policy measures to create jobs, increase labour supply and improve matching on the labour market would stimulate growth, improve the sustainability of public finances and reduce inequalities. However, not enough resources are allocated to education and labour market policies and there is room for efficiency gains.

Raise educational outcomes

The education budget should be sheltered from general budget cuts and to the extent possible, more resources should be devoted to this growth-enhancing area. Improving educational outcomes is a priority to increase productivity, improve the matching on the labour market and reduce inequality. While the education level has been increasing, the level and the quality of education remain below OECD averages (Figure 9). Public and private returns to education are relatively high by OECD standards with net internal rates of returns 2 to 22 percentage points above the OECD average (Šiškovič, 2011). Improving education quality would have a significant impact on future economic growth. According to OECD estimates, increasing average PISA scores of all labour force participants to OECD highs would raise GDP growth by 0.9% in Slovakia (OECD, 2010c).

Notwithstanding strong increases over the past decade, Slovakia is among OECD countries which spend least on education per student (Figure 9). Public spending on education accounts for 4% of GDP, one third less than the OECD average. Studies do not find any close relationships between the level of spending and the quality of education. Increasing education spending alone will not be sufficient to improve educational outcomes, especially as educational outcomes are relatively good given the low level of spending (Sutherland *et al.*, 2007).

Figure 9. Spending, average achievement and saving opportunities in education



1. Potential savings represent the difference between a no-reform scenario and a scenario where all schools in each country would become on average as efficient as those in the best performing country. Estimates of efficiency are based on DEA analysis at the national level with two outputs (average Programme for International Student Assessment - PISA score and homogeneity of PISA score) and two inputs (teachers per 100 students and socio-economic background of students).

Source: OECD (2012), *Education at a Glance*, Table B1.3b; *PISA 2009 database* ; Sutherland, D. *et al.* (2007), "Performance indicators for public spending efficiency in primary and secondary education", *Economics Department Working Papers*, No. 546.

Improving the allocation of funds and the evaluation of schools

While efficiency in primary and secondary education is relatively high, the allocation of available resources could be improved. Although the funding system is providing room to support poor performers it is encouraging schools to separate out very good as well as poor performers or students with behavioural problems or special needs. Premiums are allocated to eight-year grammar schools (schools for the best pupils, selected at age 10). Also, financial incentives for integrating pupils with special needs in mainstream education are quite low (Friedman and Surdu, 2009). These practices are inefficient as they may have no impact on overall educational outcomes and tend to increase the influence of socio-economic background on learning outcomes (OECD, 2010f). Thus, the planned removal of premiums for eight-year grammar schools by 2013 is highly welcome and existing incentives for integrating pupils with special needs in standards schools or classes should be developed.

The network of primary and secondary schools could also be revised. The average number of pupils per school decreased by around one third since 1990 and the average number of pupils per class is below the OECD average. Consideration should be given to merging schools while taking into account its impact on local development and make sure induced costs do not exceed benefits. Increasing the number of pupils per class should also be envisaged, for instance by modifying the upper limit on size of classes fixed by law. Removing premiums allocated to small schools and replacing them with grants not linked with the size of the school might also encourage economies of scale. Also, the structure of the secondary education network should adapt to the increase in tertiary education attainment. Strengthening the selection of pupils entering grammar schools is currently discussed to avoid a “dumbing down” of general education. While care should be taken to ensure that quality is maintained, the education system should adapt to the rapid development of demand for higher education and provide opportunities for pupils to pursue their studies. The government should ensure vocational schools are adequately preparing pupils to succeed in tertiary education.

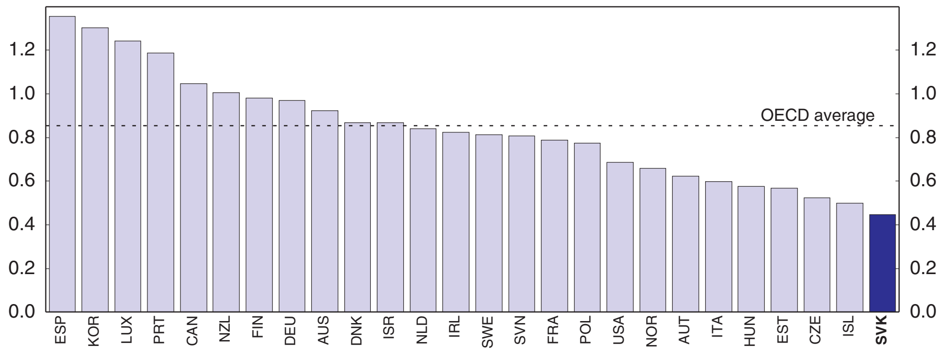
Recent reforms providing more autonomy to schools should improve the efficiency of budget management at the local level. However, additional actions to ensure that the high level of autonomy generates high quality outcomes and to monitor equity across the school system are needed. Available evaluations of schools outcomes which are currently used to assess the level of pupils and the outcomes of schools should be extended to also identify dysfunctions as well as best practices. In particular, individual school evaluations by the Inspectorate can go beyond ensuring compliance with regulations and can play a key role in making use of information in order to improve the quality of teaching and learning. Efforts to introduce value-added measures of school performance would complement evaluations by the Inspectorate because published school average results are not adjusted to take account of the context of each school and as such are open to misinterpretation and “cream skimming”. More robust measures would help to target schools with difficulties and facilitate the diffusion of successful teaching methods.

Allocating more resources to teaching activities

The best performers in PISA are countries which invest in teachers (OECD, 2012a). But teachers in Slovakia are among the worst paid in the OECD (Figure 10). On average, a teacher earns less than half the average wage of a tertiary graduate, compared to between 77% and 89% in the average OECD country (OECD, 2011c). Bringing up teacher remuneration to 75% of the average wage of a tertiary graduate would require a pay rise of around 50%, costing around 0.5% of GDP. The low attractiveness of the remuneration may partly explain the low quality of teaching, in particular in certain fields which require scarce skills or skills valued by the private sector. For example, in 2010/11, around half of English courses were provided by unqualified teachers (State School Inspection, 2011). The wages of teachers should be increased to improve the attractiveness of the profession while at the same time creating incentives for quality improvements. This should be accompanied by a widening of performance monitoring and pay. The share of best practices should be encouraged by rewarding collaborative practices and outcomes. This could be partly financed by efficiency gains. According to OECD estimates, eliminating inefficiency in primary and secondary schools could save up to 0.4% of GDP (Figure 9).

Figure 10. Teachers' remuneration

2010 or latest available year



Note: Ratio of teachers' salary after 15 years of experience to earnings of full-time, full-year workers aged 25-64 with tertiary education.

Source: OECD (2012), *Education at a Glance*, Table D3.1.

Raising support to disadvantaged pupils

In Slovakia, the share of pupils with a poor reading proficiency in PISA is significantly higher than the OECD average and the impact of disadvantaged socio-economic background on educational performances is significant. In particular, the Roma student population has very poor educational outcomes, with less than 20% of them reaching an upper secondary education level. According to PISA scores, best performing school systems are those which commit themselves to ensuring that all students succeed (OECD, 2012a), suggesting that more resources should be provided to support disadvantaged pupils. Good-quality early childhood education has a positive impact on future educational outcomes, in particular for children from socio-economically disadvantaged backgrounds (OECD, 2010d). The currently low participation of Roma in pre-primary education should be encouraged by making pre-primary education mandatory or by giving priority access to low income families.

While legislation is in place to avoid discriminatory placement of Roma children in special schools and classes, some evidence tends to show that Roma children are disproportionally placed in special educational programmes providing a low quality of education and *de facto* excluded from higher levels of the education system (Friedman and Surdu, 2009; World Bank, 2012). These practices should be avoided and financial incentives for schools to integrate Roma in standard classes should be strengthened. In the National Roma Integration Strategy, Slovakia defines a broad range of measures that should be quickly implemented and regularly monitored. Current changes in the financing formula that oblige schools to devote a certain share of financial resources to disadvantaged pupils are welcome and measures to provide special assistance to least performing students should be developed further. In particular, the tracking system of children into special schools should be reformed and the number of teaching assistants should be increased as envisaged in the Strategy.

Improving school-to-work transition

With Slovakia having the third highest youth unemployment rate in the OECD in 2011, transition from school to work is an increasing concern. In particular, unemployment is prevalent among graduates from vocational schools, who accounted for 64% of the youth graduates in 2009, 20 percentage points more than the OECD average. In 2010, the unemployment rate of 24-35 olds graduated from a vocational secondary school was four percentage points higher than for graduates from general secondary schools. The reasons behind the low performance of vocational schools are difficult to identify as information on the Slovak vocational education and training (VET) system can be improved further. This could be done through an OECD review of the VET system.

Available indicators suggest that the VET system may not have adapted to the structural changes of the labour market. Improving the matching between employers' requirement and vocational education requires developing mechanisms to regularly identify current and future labour market needs. In this respect, VET councils involving business representatives and aiming at discussing and defining the educational programmes at the regional and sectoral level have been established. Also, the system of competency-based curricula introduced in 2008 and including transferable knowledge should ensure a good balance between developing professional competences that increase the chances for immediate employability and providing transferable knowledge increasing adjustment capabilities during structural shifts in the economy and through the whole lifetime of the worker. More consideration should be given to the development of short (2-3 years), flexible, and more vocationally-oriented tertiary programmes to better adjust to structural changes in labour market requirements. These programmes are under-developed in Slovakia, though they could bring tertiary education closer to the labour market needs and reduce the length of studies, while being more accessible to VET graduates willing to pursue their studies.

Acquisition of professional experience during studies should be fostered. Studies highlight that in-work training improves school-to-work transition for VET graduates (Hoeckel, 2008; OECD, 2010b). However, only 30% of VET pupils participate in some form of workplace training in Slovakia. The apprenticeship system is not attractive to firms, even if some measures have been implemented to simplify the hiring of trainees or have created financial incentives for firms to provide training. One option to foster work-based VET would be to create a legal framework for a dual apprenticeship system (alternation of class and work as in Germany or Austria). Indeed, dual apprenticeship systems deliver outcomes in terms of skill acquisition that appear to better equip workers to take advantage of changes in labour demand (OECD, 2012b). At least, curricula should include more compulsory internships to better prepare graduates to enter the labour market.

Without national standards for assessment of competences, certificates delivered by VET schools provide employers with limited information on the nature and the level of graduates' competences hindering the recruitment of VET graduates, also contributing to reduced regional mobility. A national system of certification of competences acquired in the VET system could improve labour market matching by reducing asymmetric information between employers and employees (OECD, 2010b). Since 2008, competency-based curricula have been established based on national standards and certificates delivered by VET schools include information on the competences acquired. Providing a consistent method to assess the learning outcomes of vocational programmes would also ensure that all those with the same qualification have the same competences, at a similar level and underpin quality and consistency in the VET system as well as remove barriers for regional mobility.

Developing lifelong learning

Developing lifelong learning is also essential to adapt skills to structural changes in labour market requirements, avoid the erosion of qualifications and provide a second chance to early school leavers. While participation in adult education is relatively high in Slovakia, the number of expected hours in training during a working life is significantly below the OECD average (OECD, 2011c). Slovakia launched the "Lifelong Learning and Lifelong Guidance Strategy" in 2007 but few measures have been implemented since then. A National System of Occupations is being developed, a National System of Qualification is to be established to ease the recognition of competencies acquired through non formal education, and a Further Training Information System is also established to improve access to information on training options. Providing information on the quality and returns of training and ensuring recognition of learning outcomes in the labour market and in the educational system is crucial for the good functioning of the training market. These initiatives should thus be pursued further while ensuring a close cooperation with the abovementioned councils in charge of defining the educational programmes in VET schools to avoid overlaps.

The cost of training and the difficulty of combining training and work are the main hurdles to participation in adult learning in Slovakia (Eurostat, Adult Education Survey) and little has been done in these areas. Incentives for firms to provide training are weak and adult learning is mainly funded by the public sector. Participation of low qualified and older workers in adult education is particularly low. Incentives for employers to allocate more resources and time to training should be enhanced, for instance by deducting training costs from the corporate tax base. Public support should be targeted to low qualified and older workers.

Box 2. Key recommendations for education policy

- Remove premiums to eight-year grammar schools as planned and strengthen incentives for the integration of pupils with special needs in the standard system.
- Improve the use of available evaluations to identify dysfunctional schools as well as best practices.
- Increase the wages of teachers together with structural measures increasing the efficiency of the system such as consolidating the network of schools, increasing the classroom size and widening the scope for performance-related pay.
- Raise support to disadvantaged pupils. Further encourage participation of children from low-income families and Roma in pre-primary education and the integration of Roma in mainstream education.
- Foster acquisition of professional experience during studies and work-based vocational education and training by creating a legal framework for a dual apprenticeship system.

Improve labour market performance

Removing barriers to wage flexibility and labour mobility

Being a member of a monetary union requires having a flexible labour market to adjust to shocks. Wage flexibility and geographical mobility are keys in this respect. Recent reforms of the legal extension are going in the right direction. However, remaining labour market rigidities should be removed, in particular the regulation stipulating that employees not covered by collective wage agreements are subject to a minimum wage that differs by the type of work. These wage floors may be a hindrance to local wage adjustment and should therefore be phased out (OECD, 2010a). Also, the labour code has been reformed twice since 2011 (Box 3). The induced instability in the labour legislation may weaken business confidence and generate adaptation costs for employers. Also the impact of the recent measures has not been adequately analysed and some changes may have a negative impact on employment. In addition, more should be done to foster geographical mobility, addressing the unusually large regional differences. Among contributing factors is the absence of an adequate rental housing market. The housing sector should be reformed as recommended in the *2009 Economic Survey* (OECD, 2009).

Box 3. Recent and future changes in the labour code

The labour code was amended on 1 September 2011, easing employment protection legislation (EPL) for both permanent and fixed-term contracts. After this reform, EPL strictness has been among the lowest in the OECD and the differences between protection of permanent and temporary contracts have been significantly reduced (Harvan and Machlica, 2011). The labour code was reformed again in October 2012 with measures partly undoing some of the 2011 changes. While not strongly undermining employment, these reforms - effective on 1 January 2013 - might have some negative effects on job creation. Some measures are quite positive though, as they increase the flexibility in working hours.

- Protection of permanent contracts will be tightened closer to 2010 levels. The simultaneity of redundancy payment will be re-introduced and the possibility to reduce the notice period by collective agreement removed. While employment protection of regular contracts will not become excessively tight, these measures will tend to reduce job turnover and may undermine productivity growth. By increasing firing costs and thus the risk of higher costs in the event of dismissal, this type of regulation may depress hiring.
- The 2011 changes in the regulation of fixed-term contracts will be repealed. The maximum

cumulated duration of temporary contracts will be reduced from three to two years and the maximum number of renewals from three to two within two years. Reducing differences between permanent and fixed-term contracts is welcome as it limits the risk of labour market duality.[1]

- The impact of the envisaged amendments of the labour code on the flexibility of working hours is mixed. The legislation includes the obligation for firms to find an agreement on flexible working hours with employee representatives. At the same time, employers will be allowed to balance the working time accounts in 30 months (instead of 12 months previously). This measure is welcome as the flexibility in working hours allows firms to adjust to the business cycle and reduces volatility on the labour market, as demonstrated by the German example (Hüfner and Klein, 2012).

1. Differences in protection of permanent and temporary contracts may lead to labour market duality inducing lower human capital accumulation and higher income inequality but would not reduce unemployment (de Serres *et al.*, 2012; Koske *et al.*, 2012).

While the tax and social security burden on labour has declined significantly since 2004, it remains particularly large for low income earners, with a tax wedge for a single person earning 67% of the average wage which is some 4 percentage points higher than the OECD average (Table 5). This hampers labour demand for low wage earners, who make up the largest share in the unemployment pool. Consideration should be given to reducing social security contributions paid by employers for low-income workers to boost labour demand.

Table 5. Tax wedges

2011	Slovakia	OECD
Single 67% of average wage	36%	32%
Single average wage	39%	35%
Single 167% of average wage	41%	40%
Single parent 2 children 67% of average wage	24%	16%
One-earner couple 2 children average wage	25%	25%
Two-earner couple 2 children 100% + 67% of average wage	33%	30%

Source: OECD (2011), *Taxing Wages*.

Strengthening work incentives

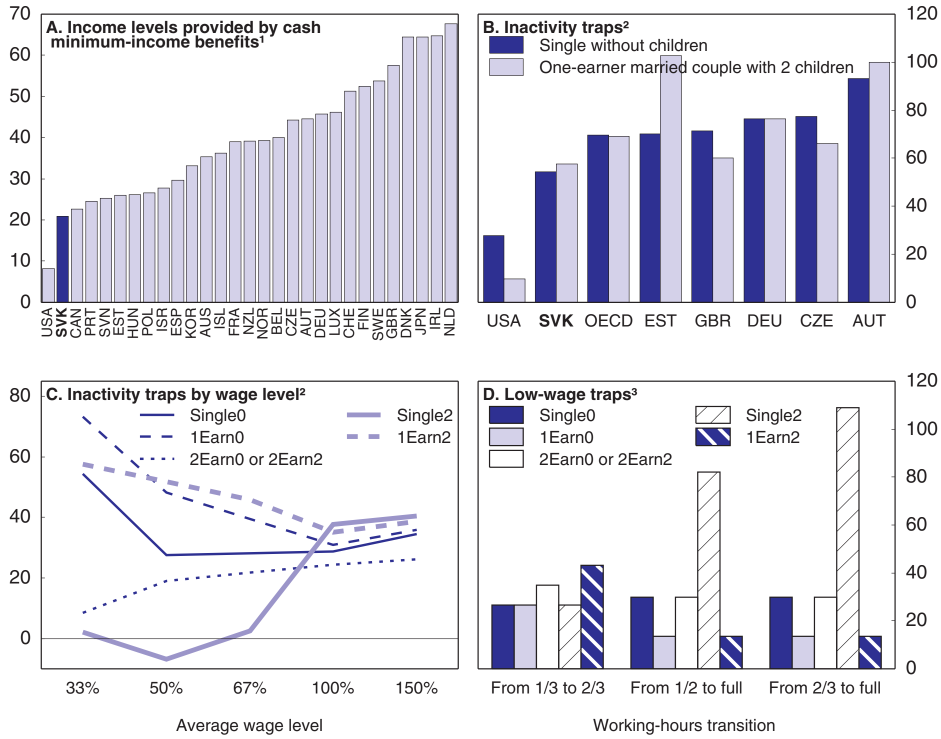
Notwithstanding the relatively high tax wedge on low-income workers, overall, the tax and benefit system generates fewer disincentives to work, even for a low wage, than on average in the OECD. The level of social assistance benefits is very low, with minimum income benefits amounting to only 20% of the median income, well below the poverty threshold. Also, the inactivity traps are lower in Slovakia than in most other OECD countries (Figure 11).

There is room to improve work incentives further, however, while continuing to protect the most vulnerable. Contrary to most other OECD countries, Slovakia does not encourage job search activities for social benefit recipients. Registration of social benefit recipients with ability to work in placement services should be made mandatory. Also, the social assistance system is quite complex and benefit recipients may not be aware of available financial and material support.

Furthermore, the net economic gains associated with low paid jobs are not significant in a number of cases. The average and marginal effective tax rates of labour revenues varies widely depending on household composition and on the wage level, for instance exceeding 80% for one earner couples receiving the activation allowance (Figure 11). The in-work tax credit (employee bonuses) introduced in 2009 is quite low and not well targeted: some low-income workers (those earning less than 6 times the monthly minimum wage per year or working less than six months during a year) are not eligible. An activation allowance is allocated to long-term unemployed taking up a full time job or to all benefit recipients with material need and with the ability to work participating in activation activities, such as training or small community work. The allowance is too low to compensate the losses of benefit received to cover basic material needs for those taking formal jobs and is not paid to those working part time. It reduces work incentives for those participating in activation activities. The social assistance system should be reformed to get the balance right between poverty alleviation and activation for both improving income adequacy and reducing benefit dependency. In-work benefits should be merged to simplify the system and to better target to those who may not gain a lot from taking up a job, such as part-time workers.

Figure 11. Work incentives

2010



Note: Type of family: Single0 = Single person, no children; 1Earn0 = One-earner married couple, no children; 2Earn0 = Two-earner married couple, no children; Single2 = Lone parent with 2 children; 1Earn2 = One-earner married couple with 2 children; 2Earn2 = Two-earner married couple with 2 children.

1. Net income value including cash housing assistance in % of median household incomes, 2010.
2. Average Effective Tax Rates for a transition into full-time work for persons without entitlement to unemployment insurance but entitled to social assistance. Panel B refers to inactivity traps at 33% of the average wage.
3. Marginal Effective Tax Rates for part-time employees in 2010 for different working-hours transition (in %).

Source: OECD, Benefits and Wages: Statistics.

Female labour participation is relatively low in Slovakia, in particular for mothers with dependent children (59% *vs*. 66% on average in the OECD and more than 85% in some countries). The length of the maternity leave and of the parental leave is high by international standards. Combined with a lack of affordable childcare options, this may be associated with career interruptions and thus a low female participation. A six-month maternity leave is considered as providing a good balance between child well-being and mother's employment opportunities (OECD, 2011a). In 2011, the length of maternity leave was increased to 34 weeks in Slovakia (*vs*. 19 weeks on average in the OECD) and the replacement rate rose from 60% to 65%. The mother can decide to finish the maternity leave or transfer her claim on maternity benefit to the father of the child. Parental leave is paid for 136 weeks, two times the OECD average. Countries with shorter periods of leave have higher employment rates among mothers with young children than countries with prolonged periods of paid leave. Long interruptions of work complicate career aspirations, reduce the return on education and the incentives of employers to invest in on-the job training. Too long parental leave may also deteriorate skills and make the return to work difficult (OECD, 2011a). The recent measures on maternity leave should be reconsidered. The length of parental leave should be reduced or at least the parental allowance should be increased for parents choosing to reduce the length of their parental leaves, as done in Austria.

Reforms to maternity leave should be combined with an expansion of childcare facilities which are insufficiently developed. The childcare enrolment rate is the lowest in the OECD (below 40% *vs*. 58% on average in the OECD) and is more than three times higher for high income households than for low income households, one of the worst ratios among OECD countries. Childcare places should be increased and priority given to low income families or at least childcare fees should be means-tested. Beyond their positive impact on female labour market participation, these measures may also contribute to reducing the gender wage gap, which is more pronounced in Slovakia than in the EU-27 average (Kusa and Gerbery, 2010).

Reforms to maternity leave and childcare may not reduce fertility. The effect of policies on the fertility rate is found to be small, the duration of the maternity leave in particular (Sleebos, 2003). Also, countries with the highest female employment rates are also among the countries with high fertility rates. Available evidence suggests that policies which help women reconcile work and family, such as the availability of childcare services, may stimulate both labour market participation and fertility (OECD, 2011a).

Raising spending on and efficiency of active labour market policies

The high incidence of youth, low qualified and long-term unemployment, as well as regional unemployment differences, suggest deep needs for more comprehensive activation policies. Efficient active labour market policies (ALMP) can contribute to reducing unemployment and ensure a better use of the labour force through better matching and improved mobility.

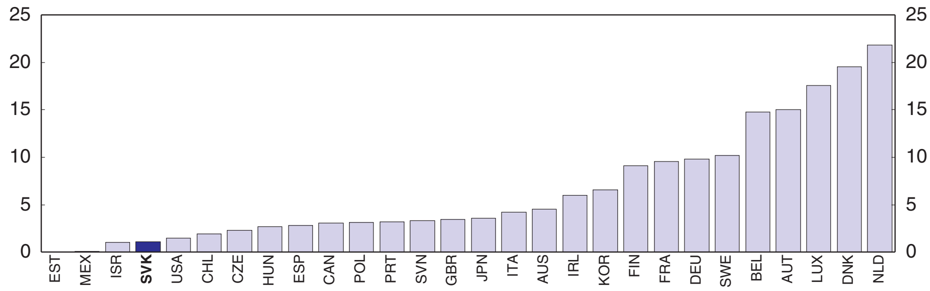
However, spending on ALMP is among the lowest in the OECD, amounting to 0.3% of GDP compared to an OECD average of 0.7% in 2010. Spending per unemployed is more than ten times below the OECD highs (Figure 12) and has been quite volatile over the past few years. ALMP are mainly financed trough EU funds, which require burdensome administrative procedures, and thus lack flexibility to adapt to labour market needs. Programmes are not targeted towards the most vulnerable groups, which are underrepresented among ALMP participants. Low qualified unemployed account for 40% of participants and 60% of total unemployed. Participation to ALMPs is lower in regions with a high share of long-term unemployed. Also, a large number of available programmes are not used.

Analysing local labour market outcomes, identifying the pockets of underperformance, and setting objectives could help to better define local needs for ALMPs. Also, participation in programmes should be targeted towards those who are more in need and made universally available for the most vulnerable groups. Better targeting would limit potential deadweight losses and create some financial room to develop more intensive ALMPs for in-need groups.

As data on programmes outcomes and evaluations of ALMPs are lacking, their efficiency cannot be fully assessed. However, available evidence points to low effectiveness (*e.g.* Harvan, 2010, on two particular programmes). Thus, while the low level of spending on ALMPs suggests more resources should be allocated in this area, spending on these programmes should only be increased after a proper evaluation of their impact has been made available. The planned data collection and systematic evaluation of the ALMP should be implemented by using international benchmarking. New programmes could be tested with pilot projects before being implemented at the national level.

Figure 12. Spending on active labour market policies

2010, in thousand USD PPPs per unemployed



Note: Active labour market policies cover programmes dealing with PES and administration, training, job rotation and job sharing, employment incentives, supported employment and rehabilitation, direct job creation and start-up incentives. Data refers to 2009 for United Kingdom. Data for other OECD countries often include training allowances, wages or other forms of income support paid to programme participants: Slovak data include some types of income support payment but not the "activation allowance" or regular social benefits that are paid to ALMP participants in some cases.

Source: OECD, Labour Market Programmes and OECD Economic Outlook databases.

A relatively high share of ALMP resources goes to start-up incentives (subsidies for unemployed starting a business). While evidence on the effectiveness of these programmes is rather mixed (Dar *et al.*, 1999), spending on these measures is three times higher than the OECD average (0.08% *vs*. 0.02% of GDP) and continues to increase. According to available evidence, net positive effects of start-up incentives on employment are quite low due to significant deadweight and displacement effects. In Slovakia, start-up incentives are generous, not targeted and not carefully monitored. Eligibility criteria should be made stricter and the monitoring of the measures strengthened.

Empirical evidence tends to show that, together with employment incentives, public employment services have the largest positive impact on labour market outcomes (OECD, 2005). In Slovakia, PES services are understaffed and underfinanced. The number of unemployed per PES employee was among the highest in the OECD in 2006 and rose significantly in the aftermath of the crisis. Also, only a small share of resources is allocated to placement services (compared to social services) and the two services are not cooperating. In addition, on top of the job assistance services, PES employees are responsible for registering vacancies and collecting information on the labour market developments. As a result, PES cannot deliver client-oriented individualized services, and positive initiatives, such as the introduction of Individual Action Plans provided to vulnerable jobseekers, are not bearing fruit. PES services should be reorganised by creating one-stop shops for jobseekers. More resources should be allocated to placement services. Effective online collection of job offers should be established to lighten workload of PES employees.

Employment incentives should also be developed because such programmes - wage subsidies in particular - are found to be effective in fostering employment (Kluve, 2010) and would reduce the tax wedge from its currently high level. Incentives should be tightly targeted on long-term jobseekers with low productivity to limit crowding out effects. Placement of long-term unemployed into firms could also be directly promoted, for instance by reducing hiring costs, as such initiatives proved to be effective in the past (*e.g.* in US Steel in Kosice). These policies would be more effective than public works measures, which are currently the main policy targeted towards long-term unemployed. Such measures provide additional revenues to the unemployed and a work routine but do not increase the employability of participants. They can even lock in participants in unemployment as they divert them from looking for a job (Card *et al.*, 2009 and Harvan, 2010). The length and the number of participation in these programmes were reduced in 2008, but job creation programmes still account for a large share of ALMP participants. Job creation programmes should be proposed only when no other options are available and should be complemented by other activation measures, improving the employability of the participant. In particular, these programmes should not be allocated to early school leavers or young unemployed.

In 2009, the share of training in the total ALMPs spending was very low, accounting for only 2% of total spending, six times less than in the average OECD country (27% of spending). Well designed training programmes, in particular those which are job-related and defined in collaboration with local firms improve the employability of job seekers and contribute to addressing labour shortages and skills mismatch. However, public procurement rules for training services induce high administrative barriers and are not used by local labour offices. Training should be supported by simplifying the public procurement procedures and by training PES staff in procurement law. Strong incentives for training providers to offer high quality and job-oriented training should be introduced, for instance by establishing outcome-oriented funding and requiring the certification of acquired competences.

Box 4. Key recommendations for improving labour market performance

- Encourage job search activities and participation in Active Labour Market Policy (ALMP) by all benefit recipients with some ability to work by making their registration in placement services mandatory. Better target the measures to those who may not gain a lot from taking up a job.
- Increase spending on those ALMP whose effectiveness has been demonstrated. Implement the planned data collection and systematic evaluations of ALMP. Consider testing new programmes with pilot projects before implementation at the national level.
- Allocate more resources to placement services in PES. Reorganize PES by creating one-stop shops. Establish an effective online collection of job offers.

Other recommendations

- Develop employment incentives targeted towards long-term jobseekers with low productivity. Foster the placement of long-term unemployed into firms for instance by reducing firms hiring costs. Propose job creation programmes when no other options are available, exclude early school leavers from these programmes and complement them with other activation measures improving employability.

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Chapter summaries

Chapter 1. Improving the fiscal framework to enhance growth in an era of fiscal consolidation

The challenge for fiscal policy is to achieve fiscal consolidation in a way which supports the fragile recovery and protects spending on areas which are important for re-embarking on a trajectory of high trend growth and underpinning a catch-up in living standards. While the recently established fiscal rules have significantly improved the fiscal framework, a further strengthening in medium-term fiscal discipline will be necessary to avoid pro-cyclical fiscal policy. Raising the effectiveness of tax collection, reforming the tax structure towards less distortive taxes and making more out of available EU funds would also play a helpful role in a growth-friendly fiscal consolidation. Finally, more needs to be done to ensure an adequate prioritisation of spending and an efficient use of public revenues. In particular, stepping up the analytical monitoring, evaluation and assessment capacity in spending ministries should help to rein in wasteful spending.

Chapter 2. Investing efficiently in education and active labour market policies

Educational outcomes are below the OECD average and are too dependent on the socioeconomic background of students. Unemployment is high and the school-to-job transition process does not work well. Spending on education and active labour market policies are very low by international standards. While reforms are under way in both areas, further efforts are needed to support the domestic drivers of growth. At a time of fiscal consolidation, these two policy areas should at the least be protected from budgetary cuts while every opportunity for efficiency gains should be seized. Not least because of the high level of long-term unemployment, more emphasis should be placed on activation policies, particularly on placement services, which are currently underfinanced but also insufficiently evaluated. Educational achievements and thus future labour market outcomes could be improved by re-allocating resources to teaching activities, in particular for disadvantaged pupils. Developing work-based vocational education would also facilitate the transition from school to work.

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.

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The Secretariat's draft report was prepared for the Committee by Caroline Klein under the supervision of Andreas Wörgötter. Statistical assistance was provided by Béatrice Guérard. The Survey also benefitted from consultancy work by Robert Price, Gabriel Machlica, Štefan Kišš, Matej Šiškovič and Jarko Fidrmuc

The previous Survey of the Slovak Republic was issued in November 2010.

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