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Report No.25211-SK

Slovak Republic
Development Policy Review
(In Two Volumes) Volume I: Summary Report

November 2002

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

Document of the World Bank

CURRENCY EQUIVALENTS

Currency Unit = Slovak Koruna (SKK)
US$ 1 = SKK 42.03
(as of November 1, 2002)

ACRONYMS AND ABBREVIATIONS

ALMP	Active Labor Market Programs
CAP	Common Agricultural Policy
CEEC	Central and Eastern European Countries
CET	Common External Tariff
CIT	Corporate Income Tax
CJSR	Council of Judges of the Slovak Republic
CMEA	Council of Mutual Economic Assistance
COFOG	Classification of the Functions of Government
CSU	Czech-Slovak Customs Union
DB	Defined Benefit
DPF	Deposit Protection Fund
EBRD	European Bank for Reconstruction and Development
EU	European Union
EUROSTAT	Statistical Office of the European Commission
FDI	Foreign Direct Investment
FIE	Foreign Investment Enterprises
FMA	Financial Markets Authority
GDP	Gross Domestic Product
GHIC	General Health Insurance Corporation
GP	General Practitioner
HEI	Higher Education Institutions
HIC	Health Insurance Company
IAS	International Accounting Standards
IFP	Institute for Financial Policy
IIPE	Institute of Information and Prognoses on Education
IMF	International Monetary Fund
IMR	Infant Mortality Rate
INEKO	Institute for Economic and Social Reforms
MNC	Multinational Corporations
MoE	Ministry of Education
MoF	Ministry of Finance
MoH	Ministry of Health
MoJ	Ministry of Justice
MoLSAF	Ministry of Labor, Social Affairs, and Family
MSL	Minimum Subsistence Level
MTBF	Medium-Term Budgetary Framework
MTPC	Ministry of Transport, Posts and Communications

NBS	National Bank of Slovakia
NDC	Notional Defined Contribution
NKU	Supreme Audit Office
NLO	National Labor Office
NPF	National Property Fund
NPL	Non-Performing Loans
OECD	Organization for Economic Co-operation and Development
OPT	Outward Processing Trade
PAYGO	Pay-As-You-Go
PEP	Pre-Accession Economic Program
PIT	Personal Income Tax
PPA	Public Procurement Act
PSO	Public Service Obligations
RONI	Regulatory Office for Networks Industries
SBRA	Social Benefits Reform Administration
SE	Slovenske Elektrarne
SGI	Slovak Governance Institute
SI	Sickness Insurance
SIA	Social Insurance Agency
SITC	Standard International Trade Classification
SKA	Slovak Consolidation Agency
SME	Small-Medium Enterprises
SOP	Sectoral Operational Programs
SPP	Slovak Gas Utility
SRA	Slovak Road Administration
TEN	Trans-European Network
TINA	Telecommunications/Informatics Infrastructure New Assistance Products Program
UI	Unemployment Insurance
UVO	Public Procurement Office
VAT	Value Added Tax
WTO	World Trade Organization
ZS	Zeleznicna Spolocnost; Railway Company
ZSR	Zeleznice Slovenskej Republiky; Railways of the Slovak Republic

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ACKNOWLEDGMENTS

This report was prepared by a core team comprising Bernard Funck (main author), Marcelo Bisogno, James Harrison, and Anton Marcincin, based primarily on specific contributions and background papers by Bartek Kaminski and Beata Smarzynska (trade integration); Emily Andrews and Patrick Wiese (social protection); Martin Bruncko (regional development); Lubomira Zimanova Beardsley and Alexey Proskuryakov (judiciary reform); Marie Renee Bakker (financial sector); Csaba Csaki and his team (agriculture); and Roland Clarke (public expenditure management).

The team also drew upon the work of Mukesh Chawla (health), Mary Canning and Halil Dundar (education), Jean Jacques Dethier (public expenditure management), Istvan Dobozi and Laszlo Lovei (energy), Ana Revenga and her team (poverty), Dena Ringold (Roma); and Lodovico Pizzati (fiscal sustainability).

The team gratefully acknowledges its indebtedness to the analytical work of the IMF, the OECD (particularly its latest country survey focusing on labor markets), and the European Commission.

The team is also grateful to Roger Grawe, Kyle Peters, Ingrid Brockova, Milan Brahmbatt, and Roberto Rocha for their support and advice.

The production of this report would not have been possible, however, without Anita Correa and Emily Evershed's excellent support in respectively processing and editing the manuscript. Oana-Maria Croitoru also helped put together the statistical data.

EXECUTIVE SUMMARY

The Slovak Republic's external current account and fiscal deficits (net of privatization receipts) are unsustainably high (at about 8 percent of GDP in 2002), despite some recent declines. With a capital account surplus of perhaps 20 percent of GDP this year, the Slovak Republic may not find it particularly difficult to finance these deficits, but this favorable situation will not last. Furthermore, through its impact on the real exchange rate, this policy mix is undermining the employability of large segments of the population (particularly those with low skill levels) and will ultimately choke growth (projected at 4 percent for 2002). While much policy attention has gone to stimulating investment, future growth will also depend on raising the employment rate, currently one of the lowest among the CEECs at 50 percent of the working age population.

The next year and a half that separates the Slovak Republic from EU accession offers a window of opportunity to act on these key issues. The new government will be well advised to take advantage of this opportunity to deliver the following *immediate 11-point agenda*:

(i) Curtailing *enterprise (current and capital) subsidies and other guarantee payments* (currently the highest among the CEECs at about 6 percent of GDP), including by pruning down all non-CAP compliant agricultural support and sharply reducing transfers to railways.

(ii) Redirecting, rather than expanding, existing expenditure programs to meet the eligibility criteria for *structural funds* financing (including to facilitate the maturation of a growth pole around Bratislava).

(iii) Further increasing the *retirement* age to 65 for all to put public pensions on a sustainable footing and avoid the massive fiscal deficits the demographic transition is bringing.

(iv) Postponing the *revenue* reduction planned under the pre-Accession economic program (from 38 percent of GDP in 2000 to a projected 35 percent of GDP in 2002, to a target of 33 percent of GDP in 2004) until such time as the expected cutback in expenditure has actually materialized.

(v) Rebalancing the tax burden away from payroll taxes (starting with health and sickness contributions) and toward other tax bases (e.g., by streamlining VAT refunds, by taxing away windfall gas profits, by trimming down tax incentives for investment to EU-compatible levels, and by subjecting all personal income -- including child allowances, if they remain universal-- to the personal income tax.

(vi) Bringing forward the planned increases in *electricity and natural gas tariffs* (with targeted lifeline blocks for low income consumers, if necessary).

(vii) Using privatization receipts from abroad to retire *foreign rather than domestic debt* (to avoid further stimulating domestic demand).

(viii) Starting to privatize *power generation* (nuclear and thermal separately) as well as *"unclaimed" land.*

(ix) Reducing *labor market* rigidities (which are among the highest in the CEECs), including by again revising the recently adopted labor code, by reforming the minimum wage, by decentralizing collective bargaining, and by redesigning Social Assistance benefits.

(x) Debottlenecking *debt resolution* procedures with a view to facilitating a second round of ownership transfer on those assets questionably acquired under the Meciar government and removing a critical obstacle to bank lending to SMEs.

(xi) Bringing down the *internal trade border* within the Czech-Slovak Customs Union ahead of EU accession.

Parallel with these immediate actions, the new government should also act now to set in motion *longer haul* efforts to reform major spending programs, including the following actions:

(i) In social protection, after initiating an increase in the retirement age to put the first pillar on a sustainable footing, to *shift gradually towards a mandatory fully-funded second pillar* to raise pension replacement rates, the timing being phased to ensure that the regulatory institutions are in place to supervise the second and third pillars, and to take advantage of the country's incipient access to the EU's integrated capital markets, or better, to the euro zone; and to *curb the rising cash social assistance payments* and correct the disincentives that prevent recipients from working their way off the welfare rolls, by *adjusting benefits* to more appropriate levels, *reducing the rate of withdrawal of benefits* as recipients earn income, and improving, and strictly enforcing, *activity tests*.

(ii) In health, *to contain excess demand for health care* (through more narrowly defined benefits and greater cost sharing); to *make the financing mechanism more efficient and equitable* (by merging health insurance companies, integrating collections with other social contributions, improving compliance, and broadening the revenue base); to *increase provider efficiency* (through better-designed payment mechanisms, a provider network rationalization plan that reduces overstaffing and excess hospital beds, a strong mechanism to hold providers accountable to quality and service delivery standards, and the development of management skills at the facility level); to *ensure adequate support and focus for public health functions*; and to *protect access to health services for all, especially the Roma*.

(iii) In education, *to consolidate facilities and staff at the primary and secondary levels* (particularly by intensifying and expanding the ongoing "rationalization program) with the support of *a new funding mechanism* based mainly on capitation payments; *to reorient secondary education* to better meet labor market demands (by increasing both general academic enrollments and the general academic content of vocational streams); and to use the cost savings from consolidation and reorientation *to improve quality at all levels* and *fund (along with tuition payments) gradual expansion at the tertiary level*; to establish stronger *mechanisms, including systems of national student assessments and university accreditation, to hold schools and higher education institutions accountable;* and to *ensure equal education opportunities for the Roma.*

The success of this strategy is predicated on enhancing the country's governance framework. This would involve:

(i) Transforming the medium-term budgeting and program budgeting frameworks into effective fiscal planning tools, improving the quality of underlying financial and performance information, and enhancing the systems' integrity. This should include establishing a well-designed, periodic household budget survey as a key tool for policy analysis and design.

(ii) Consolidating the recent decentralization to ensure that capacities and accountability mechanisms are in place before moving to the next phase of devolution.

(iii) Launching a major reform of the justice sector in particular to professionalize court management; to step up the investigation and prosecution of corrupt judges; and to strengthen the regulation bodies of legal professions, including to enhance client protection.

DEVELOPMENT POLICY REVIEW

THE STRATEGIC SETTING

1. *The Slovak economy has this year experienced its best growth performance since it pulled out from the financial crisis of 1998.* The economy is now on a recovery path, with output and private sector employment growth expected to reach 4 percent and 2 percent, respectively, this year (see Table 1). However, no sooner did recovery get under way and begin to generate jobs, then macroeconomic imbalances resurfaced: the fiscal and external current account deficits hover around 8 percent of GDP, while more than 18 percent of the labor force remains unemployed.

2. *The current situation differs, however, from the pre-1999 period* in at least four respects: the main drivers of growth, the sources of domestic demand expansion, the nature of the international environment, and the forms of external financing have all changed.

Growth through Structural Reform

3. First, *growth is underpinned by structural reforms rather than over-investment.* The most striking manifestation of this change has been the turnaround in enterprise profits, which rose by about 10 percentage points of GDP between 1998 and 2002. *Most of the improvement can be attributed to the sharp drop in the number of loss-making firms.* Banking sector reforms succeeded in breaking up the old-boys' club mentality that used to tie together banks and their corporate borrowers. Enterprises in turn proved more reluctant to extend credit to their clients, forcing enterprises to restructure or to go out of business. Furthermore, the government managed to privatize or close down about 40 percent of those enterprises that remained in state hands as of 1998. Better still, the quality of privatization improved, attracting reputable strategic investors. While the average domestically owned firm is still working out the stress of restructuring, those foreign-owned firms are now expanding.

4. Furthermore, while the number of profitable firms increased somewhat between 1998 and 2002, their *profit margins remained essentially unchanged*, reflecting the growing degree of competition associated with the near elimination of import tariffs with the EU and other preferred trade partners.

Table 1: Slovak Republic – Key Economic Indicators, 1995-2001

	1995	1996	1997	1998	1999	2000	2001
Real Economy							
Real GDP (growth rate)	5.8	5.6	4.0	1.3	2.2	3.3	4.0
Unemployment rate	13.1	11.3	11.8	12.5	16.2	18.9	19.4
Inflation (CPI, period average %)	9.8	5.8	6.1	6.7	10.6	12.0	7.3
Private Consumption/GDP	50.5	52.3	52.2	53.4	55.4	55.3	55.8
Gross National Savings/GDP	28.6	25.2	25.9	25.1	23.4	22.8	22.9
Gross Domestic Investment/GDP	26.5	35.6	35.2	34.7	28.2	26.4	31.9
Balance of Payments							
Trade Balance/GDP	-1.2	-11.2	-9.9	-10.7	-5.4	-4.5	-10.4
Exports of Goods and Services (growth rate in US$)	...	-0.5	8.3	10.2	-5.6	15.2	6.8
Imports of Goods and Services (growth rate in US$)	...	26.3	5.4	11.6	-13.4	13.2	15.3
Current Account Balance/GDP	2.0	-10.2	-9.3	-9.7	-4.9	-3.5	-8.6
Capital and Financial Account/GDP	7.2	12.0	8.6	8.3	7.6	7.5	9.1
Gross Official Reserves (US$ billion, end-year)	3.4	3.4	3.3	2.9	3.4	4.1	4.2
Reserve Cover (months of imports of G&S)	...	3.2	2.9	2.3	3.1	3.4	3.0
Gross External Debt/GDP	...	...	47.4	55.2	53.0	55.7	56.3
External Debt Service (% of exports of G.S.I. & T.)	...	...	...	13.3	15.5	17.1	10.5
Public Finances							
General Government Balance/GDP	...	-3.2	-4.8	-5.1	-4.3	-9.1	-8.5
Idem, excluding extraordinary items	...	-1.4	-4.3	-4.7	-4.5	-6.0	-6.6
Public Debt/GDP (%)	...	26.4	28.8	28.8	40.1	44.1	43.0
Interest Rates							
Average nominal lending rate (in percent)	16.9	13.9	18.7	21.2	21.1	14.9	11.2
Average real lending rate (deflated by CPI, in percent)	...	7.7	11.8	13.6	9.5	2.6	3.7
Average nominal deposit rate (in percent)	9.0	9.3	13.4	16.3	14.4	8.5	6.4
Average real deposit rate (deflated by CPI, in percent)	...	3.3	6.9	9.0	3.4	-3.2	-0.8
Money and Credit							
Money (annual growth)	...	15.8	-4.4	-11.4	4.2	21.5	21.3
Quasi-Money (annual growth)	...	16.4	18.3	14.6	15.0	12.5	7.7
Credit to Enterprises and Households (% growth)	...	6.0	42.7	34.9	9.2	20.9	25.2
Labor and Wages							
Nominal gross wage growth (%, period average)	14.3	13.3	13.1	8.4	7.2	6.5	8.2
Real gross wage growth (%, period average)	4.1	7.1	6.6	1.6	-3.0	-4.9	0.8
Exchange Rates							
Nominal Exchange Rate (SKK per US$, average)	29.7	30.7	33.6	35.2	41.4	46.0	48.4
Nominal Exchange Rate (SKK per Euros, average)	40.6	39.9	38.0	39.2	44.1	42.6	43.3
Nominal Effective Exchange Rate (1995=100)	100	100.7	105.8	103.6	93.4	94.5	93.2
Real Effective Exchange Rate (CPI, 1995=100)	100	100.3	106.3	106.5	104.2	116.5	116.7
Real Effective Exchange Rate (ULC, 1995=100)	100	108.6	120.0	115.6	110.6	111.0	109.8
Memo Items							
Gross Domestic Product (current SKK billion)	568.9	628.6	708.7	775.0	835.7	908.7	989.3
Gross Domestic Product (current US$ billion)	19.1	20.5	21.1	22.0	20.2	19.7	20.5
Per Capita Income (US$)	3,569.7	3,816.0	3,916.3	4,080.5	3,744.9	3,654.2	3,783.4

Sources and Impact of Domestic Expansion

5. *Second, where domestic demand used to be driven by (state sponsored) financial laxity among enterprises, it is now being fueled by greenfield investment -- which is good -- and fiscal expansion -- which is not* (see Table 2). Both phenomena are in part linked to the surge in foreign direct investment from about 1 percent of GDP annually in the 1990s to an expected 17 percent of GDP this year. Driven by greenfield investment, capital accumulation rebounded strongly in 2000 from a brief contraction in 1999-2000. Alongside greenfield FDI, however, a sizable portion of the incoming privatization receipts was also allowed to enter the domestic economy, further inflating domestic demand. This made it possible to finance (i) a gaping fiscal deficit (widening from 4.3 to 8.5 percent of GDP between 1999 and 2001); and (ii) a range of other expansionary measures (such as the redemption of National Property Fund bonds in 2001, and the retirement of domestic public debt this year) without crowding out private demand. Interest rates actually declined throughout the whole 1999-2002 period.

Table 2: Demand and Output, 1995-2002 (percent)

	1995-98	1999-00	2001-02
	Percent change		
Private consumption	6.9	0.6	4.5
Government consumption	6.9	-2.6	5.3
Gross capital formation	20.5	-10.5	10.4
Total domestic demand	9.7	-3.6	6.2
Exports	8.9	9.5	4.5
Imports	15.5	1.9	7.6
Gross domestic product	5.5	1.8	3.5
	Contribution to growth		
Gross capital formation	5.2	-3.6	4.4
Total domestic demand	9.8	-3.9	7.5
Net exports	-4.3	5.2	-4.0

6. *The recent fiscal deterioration reflects primarily the impact of policy-driven revenue losses, unmatched by corresponding spending retrenchment.* To the general tariff reduction in the context of the Europe Agreement and the Uruguay Round, and the elimination of the import surcharges imposed in 1999, the government of the Slovak Republic added a range of fiscal measures aimed at making the country more competitive and attractive to investors. These included corporate income tax (CIT) rate cuts from 40 to 25 percent and generous tax holiday schemes. Similar cuts were implemented in the personal income tax (PIT) with the marginal tax rate dropping from 40 percent to 38 percent at the highest end of the income distribution and from 15 to 10 percent at the lowest end, combined with a significant increase in the basic deduction. As a result, the ratio of general government tax revenues to GDP fell by some 7.5 percentage points of GDP between 1996 and 2001.

7. *The corresponding alleviation of the tax burden is in itself welcome as it should help fuel growth. The expenditure retrenchment on which it was predicated unfortunately never materialized.* General government expenditure (excluding net lending) actually rose by close to 2 percentage points of GDP between 1999 and 2001. Worse, recent spending measures taken in the pre-electoral phase are threatening to expand spending in areas that are primary targets for retrenchment. These measures included a 17 percent increase in civil service wages, a 5 percent hike in pensions, a ban on tuition for "external" university students, and the universalization of previously income-tested child allowances.

8. *The resulting fiscal deficits are not sustainable.* Left unattended, the current fiscal deficits would unleash explosive public debt dynamics. After starting from an almost debt-free situation at independence less than 10 years ago, the country would breach the Maastricht criteria on public debt of 60 percent of GDP as early as 2007 (see Table 3). Budget deficits are not the only risk involved. Other risks arise also from (i) the significant amount of government guarantees that the Slovak Republic has accumulated (equivalent to 18 percent of GDP as of end-2001), mainly to ensure the continued financing of troubled state-owned enterprises, such as the railway and power companies; (ii) the recurrent pressure to bailout critical sectors (e.g., health) after they have run up unbearably high payment arrears; and (iii) unexpected banking troubles (until such time as the deposit insurance scheme is recapitalized). Moreover, even after the reforms of May 2002, the pension system's deficits are projected to rise over the long run, further darkening the fiscal outlook.

Table 3: Public Sector Deficit and Debt Outcomes - Two Scenarios, 2001-09
(percent of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Reform Scenario									
1. Gross debt level	43.0	42.0	43.1	44.3	44.1	43.3	43.0	42.8	42.8
2. Gross assets	30.2	34.7	33.4	31.3	27.4	27.4	27.4	27.4	27.4
3. Net debt	12.8	7.3	9.7	13.0	16.6	15.9	15.6	15.4	15.4
4. Primary deficit	4.5	3.6	2.6	1.5	0.5	-0.5	-0.5	-0.5	-0.5
5. Interest	3.9	3.9	3.2	3.2	3.1	3.0	3.0	3.1	3.1
6. Overall deficit	8.4	7.5	5.8	4.8	3.6	2.5	2.5	2.6	2.6
No Reform Scenario									
1. Gross debt level	43.0	42.9	45.9	50.0	53.8	58.2	63.3	68.7	74.3
2. Gross assets	30.2	34.7	33.4	31.3	27.4	27.4	27.4	27.4	27.4
3. Net debt	12.8	8.2	12.5	18.7	26.4	30.7	35.9	41.2	46.8
4. Primary deficit	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
5. Interest	3.9	3.9	3.3	3.5	3.5	3.9	4.4	5.0	5.6
6. Overall deficit	8.4	8.4	7.8	8.0	8.0	8.4	8.9	9.5	10.1
Common Assumptions									
7. Nominal GDP growth	8.9	7.2	8.9	9.1	9.3	8.0	7.0	7.0	7.0
8. Privatization receipts for debt repayment	0.0	5.6	1.3	0.0	0.0	0.0	0.0	0.0	0.0

9. *Misguided incomes policies and a rigid labor market have stifled the supply response to domestic demand expansion, exacerbating the impact of the fiscal deficit on macro balances. Indicators of labor market rigidity abound* (see Table 4). Even before the labor code was recently tightened, the country's employment protection legislation was more restrictive than in the average OECD country. Under the influence of a centralized wage bargaining system, wages differ less across the country than underlying productivity. According to labor survey data, fewer than 9 percent of those who have a job are self-employed or family workers, whereas these types of working arrangements reach almost 19 percent of the employed in the rest of the Visegrad countries and 16 percent in the EU. Similarly, at 2.4 percent of total employment, part-time work is at the very bottom among the Visegrad countries (averaging 6.4 percent) and is far below the average for the EU (18 percent). Furthermore, due in part to Social Assistance benefits that are high relative to the average wage (particularly in the poorer parts of the country), labor force participation is among the lowest observed in Visegrad countries.

Table 4: Labor Force Indicators in Selected Countries, 2001
(percent)

	Slovak Republic	Poland	Czech Republic	Hungary	Slovenia	EU Candi--dates	EU-15
Employment							
Employment rate							
15-24 years	27.7	21.4	34.4	31.4	30.3	27.0	40.4
25-54 years	74.6	69.5	82.0	73.1	83.8	73.8	77.0
55-64 years	22.5	30.5	36.9	23.7	23.4	34.6	38.2
15-64 years	56.7	53.8	65.0	56.3	63.6	57.8	63.9
Self-employed & family workers	8.6	28.0	15.3	14.6	17.1	27.1	15.7
Contract of limited duration	5.0	11.9	8.1	7.5	13.1	8.0	13.4
Unemployment							
Unemployment rate							
-15-24 years	38.9	41.5	16.3	10.5	15.7	28.8	14.0
-25-64 years	15.9	15.6	6.9	5.0	4.6	11.3	6.5
-15 + years	19.4	18.4	8.0	5.7	5.7	13.0	7.3
Unemployment-12 months and more	58.3	50.1	52.9	44.8	63.3	52.4	44.0

10. To make matters worse, *a deliberate policy of rapid minimum wage increases* (by 86 percent between 1998 and October 2002) *resulted in a sharp compression at the bottom of the wage distribution*: the ratio of the minimum to the average wage rose by close to 35 percent over the period. High payroll tax rates, which at 50.8 percent of gross wages are currently at the very top among regional economies, further contributed to pricing less qualified workers out of the market. Unsurprisingly, the risk of unemployment for a worker with an apprenticeship degree is now four times higher (compared to three times in 1994) than that for a worker with a college degree.

11. With expanding demand running against supply-side rigidities, *the CPI-based real effective exchange rate,* which had initially depreciated in the wake of the floating of the currency in 1998, *promptly swung back up.* It appreciated by 16 percent between January 1999 and April 2002 (see Table 1). The comparatively greater stability of the unit-labor cost-based real exchange rate reflects *the exit or downsizing of less productive firms under the pressure of competition.* While some fast-restructuring enterprises were able to generate sufficient productivity gains to offset wage increases, other large segments of the economy struggled to compete, causing heavy job losses and soaring unemployment, particularly among low-skilled workers.

12. This rise in unemployment has no doubt had an adverse impact on living standards. An analysis of poverty in the Slovak Republic[1] found a *close link between unemployment and poverty*: a household headed by an unemployed person was five times more likely to be living in poverty than a household headed by an employed person. This finding was based on an analysis of 1996 data when unemployment was only 11 percent, and suggests that, with unemployment over 18 percent now, there would have been a very sharp rise in poverty in recent years. However, it is likely that the social assistance program has played a critical role in limiting the

[1] *Slovak Republic. Living Standards, Employment, and Labor Market Study*, World Bank, 2002.

increase in poverty following the rise in unemployment and its persistence at a high level. As unemployment rose after 1995, social assistance rolls expanded by about 80 percent (to cover a total of about 12 percent of the population, including dependants). Without this program, poverty levels would certainly be much higher (by how much is unknown, since there has been no adequate survey of household income and spending since 1996).

13. But now, with the economy growing and unemployment receding only very slowly, there is a growing concern that this *well-intentioned program may contain elements of a "poverty trap"* that could leave the beneficiaries with little incentive to move from the welfare roles into productive jobs (especially at the lower end of the wage spectrum), and thus may hinder employment growth. This concern results because benefits are high relative to average wages (especially for larger families) and because benefits are withdrawn on a one-to-one basis as recipients earn income from a job. The implications of this program, and other labor market rigidities, will need to be carefully considered as part of a strategy to broaden the growth of productive job opportunities and thus reduce unemployment and poverty.

Role of the International Environment

14. The return to rapid domestic demand expansion has been taking place in a less supportive external environment than during the mid- to late 1990s. Reflecting the country's growing integration into the global production networks of European multinational corporations, Slovak exports managed to resume their penetration of the EU market in 2001-02. But growth in that market has decelerated in 2001-02 to about half the rate observed in the 1994-98 period, dampening exports accordingly. Furthermore, trade with the Czech Republic continued to contract, as it had throughout the 1990s. With imports soaring under the pressure of domestic demand, the contribution of net exports to GDP growth turned negative again in 2001-02 (as in 1995-98). Consequently, by 2001 the current account balance fell back to deficit levels of about 8.6 percent of GDP, and it is estimated to remain at a similar level this year.

Table 5: Factor Intensity of Slovak Trade with the EU, 1995-2000 (percent)

Factor Intensity	1995	1996	1997	1998	1999	2000
	Composition of Exports to the EU					
Natural Resources	19.2	20.3	17.9	12.6	13.8	10.8
Unskilled Labor	21.8	21.0	22.5	19.3	18.3	17.9
Capital Intensive	23.8	25.8	24.9	23.1	24.5	25.0
Skilled Labor	35.2	32.9	34.6	45.0	43.4	46.3
	Composition of Imports from the EU					
Natural Resources	15.5	17.2	17.9	15.0	10.5	11.0
Unskilled Labor	7.4	9.4	14.5	16.2	11.3	14.3
Capital Intensive	53.5	60.9	58.1	54.4	38.9	47.0
Skilled Labor	24.4	36.5	38.4	42.0	27.1	35.1

15. In parallel, *the country's pattern of trade specialization shifted away from unskilled labor-intensive products* (see Table 5). While it might be desirable for the Slovak Republic to move up in the value chain over time, one could wonder whether the overall policy framework is not inducing a faster "graduation" than would be desirable, threatening to leave large segments of the population by the wayside.

Forms of External Financing

16. *The country has to date been fortunate enough to be able to finance its widening current account deficit through privatization receipts, instead of through international borrowing as was the case in the mid-1990s*; this is the fourth key difference with the past. The large FDI inflows contributed to stabilizing gross foreign debt to GDP ratios, which remain today below the 1998 levels (at about 53 percent of GDP). With record high FDI inflows this year (on the order of 17-18 percent of GDP), *net foreign debt* should drop to around 18 percent of GDP by the end of the year.

CHALLENGES AND OBJECTIVES

17. *This situation of easy external financing will unfortunately not last.* With the bulk of assets already privatized, privatization receipts are already shrinking. Unless the fiscal deficit is brought under control, the resulting interest rate hike would be sure to choke recovery, bringing unemployment even higher.

18. Under the circumstances, the incoming government will need to chart a feasible course in the direction of three objectives: (i) invigorating the recovery of GDP growth and (ii) broadening the incipient employment growth, while (iii) securing external stability.

Achieving all three objectives will require a combination of the following three instruments:

(a) *Continued trade, finance, and enterprise reform*
(b) *Fiscal consolidation*
(c) *Labor market reform*

19. The next year and a half that separates the Slovak Republic from EU Accession offers a window of opportunity to act on these key issues. The drive to meet the obligations of membership should provide the framework and impetus for much of the needed policy actions. This is true in such diverse areas as agriculture, trade, financial sector development, energy, regional development, and government financial control. As the prospect of membership becomes closer, the country will also be called on more pressingly to live up to the commitments made in its Pre-Accession Economic Program (PEP), as a prelude to the discipline of the European Monetary Union. Beyond that, the decision by the Slovak Republic (like the other candidate countries) to espouse the so-called "Lisbon Strategy" for turning the enlarged EU into "the most competitive economy in the world with social cohesion and full employment of 70 percent of the adult population" (compared to 49 percent at present in the Slovak Republic) is expanding the policy agenda from merely clearing the formal hurdle for EU membership to actively contributing to the overall goals of the EU.

20. The benefits of those policies will arise from *their actual implementation, not from pro forma legislation*, as will be seen below. Only if the government has the institutional capacity to carry these policies out will the expected benefits materialize. The results of a recent perception survey (reported in Table 6) indicate that the Slovak Republic has come a long way in improving the effectiveness of its administration and the quality of the governance framework more generally. That being said, the country still rates among the lowest on most counts among acceding countries, indicating the urgent need to step up efforts.

Table 6: Perceived Quality of Governance in the CEECs, 1997/98 – 2000/01

	Government Effectiveness		Regulatory Quality		Rule of Law		Control of Corruption	
	1997/98	2000/01	1997/98	2000/01	1997/98	2000/01	1997/98	2000/01
Acceding countries								
Czech Republic	0.59	0.58	0.57	0.54	0.54	0.64	0.38	0.31
Estonia	0.26	0.86	0.74	1.09	0.51	0.78	0.59	0.73
Hungary	0.61	0.60	0.85	0.88	0.71	0.76	0.61	0.65
Lithuania	0.13	0.26	0.09	0.30	0.18	0.29	0.03	0.20
Latvia	0.07	0.22	0.51	0.30	0.15	0.36	-0.26	-0.03
Poland	0.67	0.27	0.56	0.41	0.54	0.55	0.49	0.43
Slovak Republic	-0.03	0.23	0.17	0.27	0.13	0.36	0.03	0.23
Slovenia	0.57	0.70	0.53	0.52	0.83	0.89	1.02	1.09
Other EU candidates								
Bulgaria	-0.81	-0.26	0.52	0.16	-0.15	0.01	-0.56	-0.16
Romania	-0.57	-0.54	0.20	-0.28	-0.09	-0.02	-0.46	-0.51

Note: The range is between -1 5 (worst) to +1 5 (best).

TRADE, FINANCE, AND ENTERPRISE REFORM

21. A first set of priorities revolves around the need to amplify the domestic supply response and to boost net exports through continued reform on the supply-side. While much has been accomplished, certain critical issues remain, which the new government will now need to tackle, including the following: (i) performance has been lagging behind in the agriculture sector, owing in part to a government policy to pursue food self-sufficiency and to support inefficient large corporate farming with large subsidies; (ii) the internal border within the Czech-Slovak Customs Union (CSU) is hindering trade expansion and has allowed the country to fall behind in aligning its trade regime with EU requirements; (iii) energy sector privatization is as yet incomplete and energy tariffs, particularly for gas, remain heavily distorted in favor of residential users; (iv) biases against small business in the business framework have arisen from the preferential tax treatment provided to large (and largely foreign) investors and from the absence of actionable debt resolution procedures. Partly as a result, Slovak banks are reluctant to lend to small business.

Agriculture

22. The restructuring of the agriculture sector has lagged behind that of the rest of the economy. In response to the output collapse of the early 1990s, the emphasis of agricultural policies shifted from privatization and market reforms to food self-sufficiency. This objective was to be championed by the large corporate farms that emerged from the former collective farms, and to be backed by a complete battery of policy interventions targeted to them. Furthermore, corporate farms have enjoyed the use of the state land "unclaimed" in the land restitution process.

23. The policy proved misguided and the hopes placed in corporate farms proved disappointing. Indeed, individual farms – commercial and subsistence operations combined – currently achieve a level of productivity four times higher than corporate farms do, producing 30 percent of the agricultural output on 7 percent of the agricultural land. Similarly, while

individual commercial farms showed a small aggregate profit as a subsector, corporate farms reported aggregate losses until 2000.

24. There are indications that corporate farms are beginning to face harder budget constraints. For the first time in recent history, agricultural enterprises, taken as a whole, reported a small aggregate profit in 2001, reflecting a sharp drop in the number of loss-making agricultural enterprises (from about 725 in 1999 to about 400 in 2001), as credit conditions tightened following bank privatization.

25. The adoption of the Common Agricultural Policy (CAP) upon EU accession is expected to give sectoral profitability a further boost (even in the absence of direct payments, the higher CAP-prices would boost farmers' income by an estimated 18 percent). The country would benefit most, however, if it joined the CAP with a farming sector already restructured. Otherwise, there is a danger that the large subsidies associated with EU agricultural policies will serve to mask enduring inefficiencies in the sector rather than to modernize it, leaving the sector as a constant drag on overall economic performance. While policy instruments should be aligned with CAP requirements, the levels of support offered should be adjusted to EU levels only after the accession and with EU funding. In the meantime, policies should focus on the following:

(a) *Completing land privatization.* A strict deadline should be set for the identification and resolution of "unclaimed" land ownership. Beyond that deadline, much of the State Land Fund should be expeditiously privatized through auctions. If at all possible, the 2005 deadline for filing restitution claims should be brought forward (and late claimants given financial compensation instead).

(b) *Redirecting support policies towards the CAP.* First, the government support program needs to be redirected towards preparing farms and food industries to compete in EU-wide markets, rather than subsidizing them (see also below). For this purpose, it is indispensable that food legislation and the associated regulatory agencies be made fully compatible with the EU directives on food hygiene, inspection, and certification, and with the legal responsibilities of producers. Substantial work and educational efforts are still required to implement the relevant *acquis* (including those related to animal registers, meat testing and inspection, and the certification of food processing industries).

(c) *Further tightening budget constraints.* Following the privatization of banks and major energy utilities, and with reduced subsidies, arrears on tax payments and social security contributions remain the main loopholes to close.

Transport

26. The transport sector in the Slovak Republic faces fundamental challenges in the coming years. The sector needs to adapt and respond to long-term changes in the underlying patterns of demand and correct years of misallocation of resources that have left the basic sector infrastructure under-maintained. In addition, the supply response needs now to make room for additional demands arising from the upcoming integration with the EU. The sector needs to

address the following key problems/demands: (i) the sweeping transition-induced shifts in demand across transport modes, with rail freight dropping by over 25 percent, while road freight grew by about 70 percent (1993-2000, see Table 7); (ii) large operating losses and mounting debts and arrears in railways; (iii) the build-up of a large backlog of maintenance in roads, railways and public transport; and (iv) a major program of new transport investments, mainly for the Trans-European Network (TEN) corridors.

27. In addition to resolving these issues, the policy response should: (a) make room for an increased participation of the private sector in transport activities through privatization and commercialization of existing transport activities; (b) reduce Public Service Obligations (PSOs) and reconsider their use as a vehicle for social policy in light of the leaks to non-targeted population and the price distortions they impose; and (c) make a more intensive use of cost recovery options such as electronic tolls to contribute to the financing of new investment and maintenance.

Table 7: Trends in Goods and Passenger Transport (ton-km or passenger-km billions)

	1993	2000	% change
Goods Transport			
Rail	14.17	11.23	-26
Road	16.80	28.58	+70
Inland Water	1.60	1.38	-15
Air	0.057	0.022	-59
Oil Pipeline	-	2.08	-
Total	32.63	43.29	+32
Passenger Transport			
Rail	4.57	2.87	-59
Automobile	14.36	24.41	+69
Bus	12.34	8.68	-42
Inland Water	0.006	0.004	-50
Air	4.46	2.51	-77
Total	35.74	38.47	+8
(Thousand passengers/year)			
Urban Public Transport	649	405	-60

Source: Statistical Yearbooks of the Slovak Republic.

28. The supply response remains biased towards: (i) new motorway construction -accounting for 82 percent of total road expenditures- and (ii) excessive rail services. The bias towards new motorway construction diverts funds for road maintenance and the necessary upgrading of the existing road network to EU standards. The oversupply of rail services, on the other hand, contributes to increase losses in the sector and results in periodical assistance to the sector from the Central Government. They all combine to put extra pressures to the already strained fiscal situation in Slovakia. In dealing with these expenditure pressures, the Slovak Republic will need to concentrate scarce public resources exclusively on those activities where the private sector cannot operate and/or invest effectively. It needs to reallocate public funding progressively away from decaying sub-sectors (i.e. railways) into the most dynamic ones (roads) with due consideration of environmental and social issues as well as balancing carefully the urgent needs for repair and maintenance against proposals for new investment in the area of road infrastructure. The sector needs also to complete the commercialization and restructuring of transport activities (especially in railways).

Road Infrastructure

29. Demands for maintenance and capacity increase to EU standards should be carried out minimizing the demands for budget funding. This would require a combination of new cost recovery alternatives and EU funding. To correct the backlog in maintenance and to increase capacity in both basic and high standard road network would require a 2.3 fold increase in funding. However, by no means this should translate into a corresponding increase in state

budget allocations. A number of alternative source of funding are available. They include the use of structural and cohesion funds which are becoming increasingly available to the Slovak Republic. These sources could cover up to 75 percent of individual Slovakia TINA (Telecommunications /Informatics Infrastructure New Assistance) projects. Alternatively, the financing of motorways and expressways could recur to the use of electronic tolls and quite generally, to various public-private partnerships (PPPs).

30. The use of electronic toll systems would allow the conversion of the motorway system into an open toll road network Along this lines, a Motorway Company (MC) would be able to securitize revenue from the existing toll network for the issuing of bonds to finance its expansion. While initially state owned, the MC could be later concessioned or sold to a private company. Revenues from tolls could provide sufficient funds for the construction of about 100km of motorway per year, allowing the completion of the remaining 356km of the planned 648km network within about 4 years after the existing debt was paid off.

31. The imminent decentralization of government functions will bring about a radical change in the way roads are administered. This will become a window opportunity to implement key changes in the sector. Current plans contemplate the decentralization of about three-quarters of the road network to the eight new regional governments and the remaining roads to the municipalities by 2005. However, these plans need to be complemented by the transferring of revenues and technical expertise to regional governments.

Railways

32. The current situation in railways is financially unsustainable with the railways resorting to expensive short term borrowing. The rail surface coverage is currently too large, contributing to increase losses; while operation of uneconomic lines due to low traffic gives the railways companies the excuse/justification not to decrease staffing. Not surprisingly, ZSR's (Zeleznice Slovenskej Republiky) staff productivity has declined over the past five years and currently compares unfavorably with railways systems of similar network size and traffic density.

33. ***Restructuring***. The reduction of the government's control of ŽSR through the creation of a separate operating company (ZS) at the time of the decentralization of responsibility for funding the PSO for passenger services provides an excellent opportunity to reorient the railway. While size considerations renders uneconomic the division of de railways infrastructure company (ŽSR) into separate regional railways; the large difference between its principal businesses -freight, long distance passenger, and local passenger services- suggests that a separation along these lines would be desirable. The present restructuring plan for the railways remains too modest. In terms of staff reductions, it would fall short of improving efficiency to the level of private railways. Once stripped of non-essential activities, the freight, intercity and regional passengers railway businesses should be able to operate with combined labor force of no more than 25,000 employees. Even this number, could be further reduced if the new regional governments decide they cannot support local passenger services. In parallel, the railways infrastructure company –ŽSR- could reduce staffing by about 10,000 employees some four years ahead of the seven years indicated in the current restructuring plan, provided a source of funding is available to cover redundancy costs.

34. As the size of the country is more appropriate to motorway-based bus services than to express passenger trains; the long distance passenger company would have an uncertain future. Few EU countries can maintain a profitable inter-urban passenger service and most depend on subsidies. Therefore, the chosen scheme, which combines the existing passenger railway assets –provided by the state at a nominal value- with private operation of an strategic operator into a joint venture is commendable. This scheme could attract existing passenger operators in EU countries with close connections to Slovakia. On the other hand, the freight operations of ZS could be a prime candidate for privatization.

35. PSO need to be reduced. In light of the ongoing decentralization, it would be desirable to have a stable system of PSO payment by multiple regional governments in place –one that will not have to be changed within a few years- to accommodate the new institutional structure of the railway. However, the overall envelope for PSO needs to be revisited and likely reduced. Its use as a vehicle for social policy should be examined in light of the leaks to non-targeted population and the price distortions they impose.

Energy

36. In contrast, restructuring is well advanced in the energy sector. The Slovak Republic has (i) unbundled the power and gas sectors and proceeded in 2002 to privatize the gas utility (SPP) and power distribution assets to strategic investors; (ii) begun to adjust tariffs toward cost-recovery levels (although that process came to a halt in the last 18 months); and (iii) established an independent Regulatory Office for Networks Industries (RONI). The key next steps will involve the following:

(a) *Privatizing power generation.* The best option from the point of view of speed, flexibility, and privatization revenue would be to sell nuclear and non-nuclear generation facilities separately, rather than as a single corporate entity. The main reason for this is that there is no precedent for the sale of nuclear plants in the region (or indeed outside of the United Kingdom and the United States).

(b) *Proceeding with the opening up of the electricity and gas markets to competition.* Under the current schedule, electricity markets should gradually be opened by reducing the eligibility threshold for access to the wholesale market from an annual consumption of 100 GWh in 2002 to 9 GWh in 2005, and by opening up the Slovak market to foreign suppliers in 2003. Foreign access will initially be subject to a cap of 5 percent of domestic consumption. As the Slovak Republic reaches agreements on a reciprocal basis (as it should seek to do), the number of actors in the electricity market will gradually expand.

The gas market has similarly begun to open up (up to 20 percent of the market, as of January 1, 2002). Access should gradually expand, first to all power and heat plants and for consumers of more than 20 million m^3/year, and later to all non-household consumers.

(c) *Adjusting residential tariffs for gas and electricity so as to eliminate the corresponding cross-subsidies ahead of EU Accession.* Although cross-

subsidization has been reduced, the ratio of residential to industrial tariffs in 2000 remained at about two-thirds of the OECD-Europe level for electricity and about one-quarter of the OECD-Europe for gas (see Table 8). Bringing tariffs in line with EU directives may now require residential tariff increases in the range of 40 percent in the case of electricity and more than 100 percent in the case of gas. The pattern adopted for electricity is to raise residential tariffs at four times the rate of inflation until the target rate is reached. No such schedule exists as yet for gas. With the expected date of EU Accession fast approaching, and with the urgent need for fiscal adjustment, there is now little scope for gradualism in phasing in the new gas tariffs. Rather, the government would be well advised to advance the process as much as possible, even into 2002. It should also consider introducing in parallel a special levy to tax away the windfall gas transmission rent that would otherwise accrue to the privatized SPP.

37. Because of the delays incurred, the *required price adjustments will be more abruptly painful for households, particularly at the lower end of the income scale, than they might have been.* Rather than that delaying the process, it would be preferable to consider introducing, on a temporary basis, a targeted lifeline tariff for the first block of basic electricity consumption or a targeted subsidy for basic heat (and hot water) consumption. These temporary subsidies could be phased out over time, as the increased cost of energy is reflected in revised Social Assistance benefits (based on new household budget survey data).

Table 8: Ratio of Residential to Industrial Prices for Energy, 1993-2001

	1993	2000	2001
Electricity			
Slovak Republic	0.60	1.19	1.43
Czech Republic	0.56	1.26	1.33
Hungary	0.81	1.33	1.33
Poland	1.40	1.76	1.68
OECD Europe	1.80	2.00	n.a
Natural Gas			
Slovak Republic	0.62	1.07	1.10
Czech Republic	0.73	1.45	1.44
Hungary	0.91	1.33	1.16
Poland	1.33	1.86	n.a
OECD Europe	2.67	3.98	n.a

38. *An important side-benefit of those price adjustments would be to relieve some of the current pressure on the balance of payments* -- either directly through substitution effects or indirectly through their income effect.

Trade Integration

39. *Eliminating the internal border within the Czech-Slovak Customs Union (CSU) ahead of EU accession* would not only reinvigorate trade with a country that remains the Slovak Republic's second largest trading partner, but would also help the Slovak Republic catch up with EU requirements "by osmosis." The CSU has so far failed to deliver one of the two major advantages of a customs union over a free trade area. The arrangement has allowed the two countries to avoid very costly rules of origin among members, as all products entering the Customs Union are subject to a low common external tariff. But trade between the two countries has remained subject to customs controls. The internal border has allowed considerable discretion in decisions affecting imports, such as the temporary imposition of import surcharges (on the Slovak side) or import deposits (on the Czech side), and the introduction of other

technical barriers to trade. Behind that internal border, also the Slovak Republic has allowed itself to fall behind in terms of adjustment to the EU trade regime.

40. *Aligning Slovak standards with EU standards together with the application of the principle of mutual recognition would help make up the lost ground and provide an extra boost to the integration of domestic firms into international supply chains* spread out over several countries, as common standards reinforce linkages between component manufacturers, assembly operations, and distributors in the final product markets. This should not be problematic, as both countries have special arrangements for mutual recognition of certificates and test results. Both countries will have a common objective: to implement the EU requirements on standardization. Both have been moving in that direction, but at a different pace. Furthermore, the proposed enhanced regulatory cooperation within the CSU and the elimination of internal economic borders could yield rapid and substantial improvement in the overall business environment and would avoid the need to attract FDI through costly tax incentives (see below).

Financial Sector Development

41. As already noted, the turnaround in enterprise performance owes much to the major restructuring of the banking sector that the government undertook in 1999-2001. Building on these stronger foundations, banking sector growth is likely to be fueled in the future by expansion into consumer finance, leasing, housing finance, and small business sector lending. In contrast, several factors will encourage larger companies to raise capital abroad—foreign ownership, EU integration, and deeper, more liquid, more reliable and cheaper markets. This would leave domestic banks to focus mainly on household and small business needs.

42. Two risks are involved in this scenario, however. One is that banks, now highly liquid (see Table 9), will seek to branch out too rashly into new, high-risk business activities in a bid to boost their currently low profits. Hence, there is a need to step up banking regulation and supervision, including (i) by mandating the use of international accounting standards (IAS) first by banks, and then by other corporations, and (ii) by not allowing the creation of an integrated financial sector regulator to distract from the efforts to enhance the supervisory capacity of the exiting regulatory bodies, the National Bank of Slovakia (NBS) and the Financial Markets Authority (FMA).

Table 9: Selected Indicators of Financial Soundness for the Banking Sector, 1997-2001
(percent)

	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01
Regulatory capital to risk-weighted assets	8.0	6.6	12.7	13.1	19.7
NPLs to gross loans	27.2	31.6	23.7	15.3	14.0
NPLs net of provisions to capital	22.5	25.2	15.7	6.9	7.9
Liquid assets to total assets	13.5	9.7	12.1	18.1	27.5
Operating profit	1.4	1.4	-0.1	0.1	-0.1
Return on Equity	2.8	-13.4	-36.5	25.2	25.3

43. The second risk is that bank lending might be guided more by the degree of enforceability of creditors' rights in different business segments, than by the economics of the underlying business propositions. In the absence of an effective bankruptcy framework (witness the mounting backlog of unprocessed bankruptcy cases in Table 10), banking may thus remain

atrophied in the small business segment. Key steps needed include: (i) modern legislation, providing for, among other features, an effective reorganization mechanism (rather than only liquidation) when the enterprise is potentially viable, and greater creditor initiative and participation; (ii) more limited scope for debtors, land registry offices, and other parties involved in bankruptcy cases to delay proceedings; and (iii) more resources for bankruptcy courts, better training of judges, and stronger regulation of trustees with a view to reducing the current backlog and making proceedings more foolproof. In addition to removing a critical obstacle to bank lending to SMEs, de-bottlenecking debt resolution procedures could also facilitate a second round transfer of ownership of assets questionably acquired during the Meciar years (including through a resolution of the bad debt portfolio of the Slovak Consolidation Agency (SKA) and their return into more productive hands.

Table 10: Bankruptcy and Settlements, 1993 - 2000
(number of firms)

	1993	1994	1995	1996	1997	1998	1999	2000
Bankruptcy proceedings initiated	538	1,115	1,530	1,321	1,755	1,831	2,161	2,008
of which:								
Processed:	169	466	591	672	488	702	1289	1547
Petition withdrawal	20	104	113	--	--	--	--	--
Cessation of proceedings	85	267	388	272	275	279	451	514
Cases handed over to locally authorized bodies	57	69	64	--	--	--	--	--
Rejection due to lack of assets	7	26	26	66	100	219	425	574
Other	--	--	--	334	113	204	413	415
Declaration of bankruptcy	11	32	74	198	427	654	665	638
Non-processed	369	649	939	2,663	3,896	5,025	5,897	6,358

FISCAL CONSOLIDATION

44. Fiscal consolidation, the second fundamental leg of government's medium term strategy, is now required both in its own right (to arrest potentially explosive public debt dynamics) and to relieve current pressures on the balance of payments. The report suggests that (i) the *external current account deficit would need to be cut back from 8.6 percent to about 4.8 percent of GDP* to keep the ratio of net foreign debt to GDP ratio at end-2002 levels throughout the next five years, and further reduced thereafter; and that (ii) to achieve this target would require *bringing down the overall fiscal deficit from the current 8 percent of GDP to about 2.5 percent of GDP* over the next four years.

45. This adjustment will be facilitated by the expected expansion in EU transfers to the Slovak Republic. With *net* transfers from the EU projected to increase by 2 percentage points of GDP, the size of the purely *domestic fiscal effort would be around 3.5 percent of GDP* by 2006 (under the proviso that structural funds are not applied to finance new spending over and above existing levels, see below). Such deficit levels would stabilize both the ratio of (gross) government debt to GDP and the ratio of net foreign debt to GDP at end-of-2002 levels. Furthermore, this strategy would set the Slovak Republic on track toward meeting the Maastricht criteria for joining the euro-zone at an appropriate time.

46. Consistent with the experience of successful fiscal adjustment in other OECD countries, the government would be well-advised to base its fiscal consolidation strategy on the following three principles:

(a) *The bulk of adjustment should be achieved through expenditure retrenchment,* primarily in subsidies and transfers and in the government's wage bill.

(b) *While this should remain a medium-term goal, the revenue reduction proposed under the country's pre-accession economic program* (from 38 percent of GDP in 2000 to a projected 35 percent of GDP in 2002, and to a target of 33 percent of GDP in 2004) *should be postponed* until the time that the expected cutback in expenditure has actually materialized.

(c) *Both revenue and expenditure should be redirected toward growth and employment objectives.*

Expenditure Restructuring

47. A comparison of spending patterns in the Slovak Republic (see Table 11) with those of the other CEECs brings out useful indications of where there is scope to restructure expenditure. Compared to the other CEECs, the Slovak Republic spends very high levels on:

(a) Transfers to non-financial enterprises (6 percent of GDP in 2001, 40 percent higher than the CEEC average), largely on account of continued large subsidies to agriculture, railways, and hospitals

(b) Public sector wages and salaries (8.6 percent of GDP, nearly 20 percent above the CEEC average), reflecting in particular the burden of disproportionately large workforces in health and education (reaching 5.6 percent of the population as compared to 3.8 percent in the other CEECs).

48. In addition, with high unemployment and the prospect of a rapid aging of the population, pressures are building up in the area of social protection. EU accession, and the access to EU structural funds that goes with it, will also create a push for additional spending on regional development.

49. To illustrate the scope for expenditure restructuring, the report examines public spending programs and issues in agriculture, regional development, social protection, health, and education, spending areas that, combined with enterprise subsidies, accounted for over two-thirds of public spending in 2001. While the report proposes both short-term and medium-term recommendations in the areas discussed below, it does not pretend to provide a fully detailed, comprehensive reform blueprint. Instead, it seeks to illustrate the difficult issues that need to be confronted. In each sector, the discussion focuses not on across-the-board cuts, but rather on reform options that can help to reduce or contain spending while improving its effectiveness in supporting the strategic goals of growth, employment, and stability.

Table 11: Expenditure of the Consolidated General Government (percent of GDP)

	1996	1997	1998	1999	2000	2001	Other CEECs 2000
ECONOMIC CLASSIFICATION							
Total Revenue and Grants	**43.5**	**40.1**	**37.8**	**39.8**	**37.9**	**35.7**	**38.0**
Total Expenditure and Net Lending	**46.7**	**45.0**	**42.9**	**44.0**	**47.0**	**44.2**	**39.6**
Total Expenditure	**45.5**	**43.9**	**41.9**	**40.3**	**43.1**	**42.1**	**40.5**
Current Expenditure	39.0	37.2	36.6	36.4	37.5	36.6	36.3
Exp. on Goods and Services	17.3	17.7	16.4	15.9	15.8	15.9	16.6
Wages and Salaries	10.1	9.8	9.7	9.4	9.1	8.6	7.1
Other Goods and Services	7.2	7.9	6.7	6.5	6.8	7.3	9.6
Interest Payments	2.1	1.9	2.8	3.2	3.2	4.0	2.6
Subsidies and Other Curr. Transf.	19.6	17.5	17.4	17.3	18.4	16.7	17.0
Capital Expenditure	6.5	6.7	5.3	3.9	5.7	5.5	4.2
Investment.	4.4	5.4	3.9	3.2	3.2	3.2	2.7
Capital Transfers	2.1	1.4	1.4	0.7	2.4	2.3	1.4
Lending minus Repayment	1.2	1.1	0.9	3.8	3.9	2.1	-0.9
Overall Deficit/Surplus	**-3.2**	**-4.8**	**-5.1**	**-4.3**	**-9.1**	**-8.5**	**-2.5**
memo item							
Transfers to Enterprises	8.0	5.3	5.1	4.2	7.3	6.0	4.3
FUNCTIONAL CLASSIFICATION							
Total Expenditure	**45.5**	**43.9**	**41.9**	**40.3**	**43.1**	**42.1**	**40.5**
General Public Services	3.7	3.7	3.1	3.0	3.3	3.7	2.9
Defense	2.3	2.1	1.9	1.7	1.8	1.6	1.5
Public Order and Safety	2.3	2.3	2.2	1.6	1.6	1.7	2.0
Education	4.4	4.2	4.0	3.9	3.8	3.7	5.2
Health	6.3	6.0	5.5	5.5	5.7	5.7	4.6
Social Security and Welfare	13.7	13.6	13.6	13.8	13.6	13.1	14.2
Housing and Communal Services	2.3	1.8	2.1	2.1	1.9	1.7	1.9
Recreation and Culture	1.1	1.0	1.0	0.8	0.9	0.9	1.1
Economic Services	7.4	8.0	6.5	5.3	8.3	6.6	4.5
Fuel and Energy	0.8	0.7	0.5	0.2	0.0	0.1	0.1
Agriculture	2.5	2.4	2.0	1.5	2.4	1.8	1.1
Nonfuel Mining and Mineral	0.7	0.5	0.5	0.2	0.6	0.4	0.2
Transport and Communication	1.6	1.4	1.1	0.6	1.9	1.6	2.4
Other Economic Services	1.8	3.0	2.5	2.9	3.5	2.7	0.8
Interest Payments	2.1	1.9	2.8	3.2	3.2	4.0	2.6
Miscellaneous	-0.1	-0.7	-0.8	-0.7	-1.1	-0.6	-0.1

Agricultural Support

50. The Slovak Republic currently spends excessive amounts to support an agricultural policy that is condemned to disappear with the imminent accession to the CAP. The level of support provided to corporate farms may have declined over the years, but the underlying policy

direction has remained in favor of self-sufficiency in food production, a concept diametrically opposed to that of the CAP. Even at the current reduced level, the Slovak Republic spends twice as much (as a percent of GDP) on agricultural support as the average CEEC (2.4 percent of GDP compared to 1.2 percent in 2000, respectively).

51. It is now time *to prune down and reformat the support programs so that they conform to CAP requirements*. First, government support programs need to terminate all programs that do not comply with the CAP (including most credit subsidies, support for modernization and restructuring to agro-processors, and tax refunds on diesel fuel used for farming purposes). This would reduce agricultural spending by about 15-20 percent. Second, other support programs need to be refitted to CAP requirements, including by adjusting *market support systems* to incorporate the potential use of quotas and to reform the current intervention scheme from an ex ante system (based on short-term forecasts on production and consumption) to an ex post system (based on the observed evolution of EU market prices); and by shifting the intervention point from the farmgate to the wholesale level for most products. *Direct payments and other current structural support measures* should also be adapted to the EU format. Upon accession, much of the remaining charges should be transferred to the EU budget, relieving the Slovak budget accordingly of this uncommonly high burden.

Regional Development

52. This is another expenditure policy issue that is gaining prominence as EU accession is approaches. The magnitude of the EU funding potentially involved is considerable (up to 4 percent of GDP in EU transfers plus counterpart funds) and could conceivably help fuel the country's convergence toward EU standards. In the absence of a carefully thought out strategy, however, this potential could easily be squandered.

53. The observation that significant regional differences exist in the Slovak Republic in terms of output per capita should not lead to the wrong policy conclusions. First, these differences reflect similarly large productivity differentials. Second, they have only a limited impact on household income and living standards. Indeed, it is the attempt to equalize living standards (through labor market and social polices) irrespective of productivity differentials that is at the core of the most worrisome form of regional disparity: the wide differences that persist in regional unemployment rates. Unsurprisingly, it is in those regions where wages are most attractive in relation to productivity (particularly Bratislava) that employment growth concentrates.

54. The experience of the Cohesion countries (Greece, Ireland, Portugal, and Spain) suggests that, to achieve the most rapid overall convergence possible, the government should target public investment to those areas in which such investment generates higher growth, even if that involves an initial widening of regional GDP differences. In the case of the Slovak Republic, some of the most promising investments in the context of EU accession may well be in and around Bratislava. Rather than to direct EU structural funds away from that region in the name of equity, the appropriate strategy would be to maximize its growth potential while facilitating the diffusion of the convergence process to other regions. This will be first of all the role of labor markets and social welfare reforms. Improving transport access between Bratislava and the

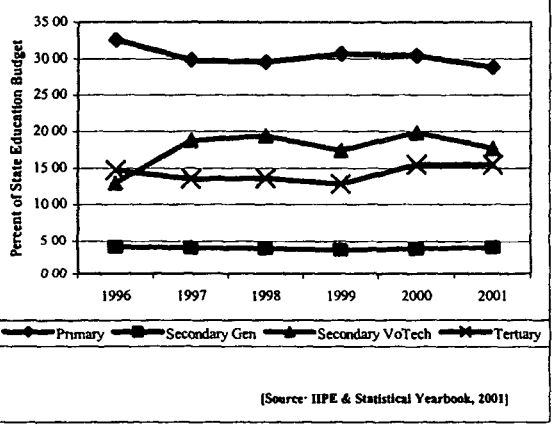
east would help firms move out of this initial growth pole as wage costs begin to rise and toward those regions that manage to establish or maintain wage competitiveness.

55. To be viable, *the utilization of structural funds will need to fit within a declining overall expenditure envelope.* The implication of the figures presented in the country's pre-accession economic program (PEP) in this respect is that, by 2006, *more than one-quarter of the monies spent on government consumption and investment will need to come from EU structural funds.* To make this possible, the Slovak government should avoid the temptation of creating new spending programs for the purpose of using EU funding. On the contrary, what is required is *a massive redirection of existing government programs to meet the eligibility criteria for EU funding* (including the so-called "additionality" criteria).

Education

56. The sweeping changes brought about by the transition are having a major impact on the demand for education, but *the supply side has not adapted fast enough or far enough in response.* This is partly because the shifts in funding needed to reorient the system have been sluggish at best (see Figure 1), continuing to generate more excess capacity in terms of teaching staff and facilities, especially where it is least needed, and suggesting the need for a new funding mechanism. For example, while enrollments in state vocational and technical schools fell by 16 percent between 1990 and 2000, the number of teachers rose by nearly 20 percent and the number of schools by over 44 percent. *The system still needs to be refocused* to provide the more general, higher-level skills that the economy needs (and students demand) by reorienting secondary education, by expanding access to tertiary education, and by raising quality at all levels. There are good reasons to believe that this can be done while keeping public spending on education at its current level of under 4 percent of GDP for some time to come, by taking advantage of the sharp drop in the school age population, the substantial potential for efficiency gains in the present system, the increasing role of private providers, and the scope for generating additional resources from tuition at the tertiary level. The challenge of decentralization also suggests the need for new, more transparent mechanisms for funding and accountability.

Figure 1: Education Spending by Level



[Source: IIPE & Statistical Yearbook, 2001]

57. The key proposals to reorient the education system include the following:

(a) *Consolidation of the excessive numbers of primary and secondary schools and teachers*, capitalizing on the sharp drop in the school age population, through an expanded and intensified "rationalization program," and the reallocation of the savings to raise quality at all levels and help fund gradual, demand-driven expansion, as well as a system of need-based scholarships, at the tertiary level.

(b) *Reorientation of the secondary level*, so that most students acquire the general academic skills needed for lifetime learning, by expanding enrollment in general secondary schools, and by reforming the technical and vocational school curriculum to increase the general academic content. These reforms should be developed in preparation for EU Accession and should be designed to facilitate access to the EU Social Fund. These measures should be coordinated with reforms at the primary level to ensure that students are well prepared for these changes. Cost savings should be reallocated to raise quality.

(c) *Introduction of tuition at the tertiary level*, both to contain excess demand and to finance the needed expansion of enrollment and quality improvements at existing institutions.

(d) *Introduction of new funding mechanisms in which "money follows the student,"* based mainly on capitation payments and numbers of students enrolled. Parallel reforms would be needed to grant schools and higher education institutions greater autonomy in using these funds (and the skills and tools to use them well), while increasing their accountability. These measures could greatly increase the incentives to consolidate and reorient the schools, and help increase efficiency, transparency, quality, and equity across different regions of the Slovak Republic.

(e) *Strengthening of the accountability mechanisms*, including *establishing a system of national student assessments* and gearing up the school inspection system, so that schools are held accountable for achieving agreed outcomes and service standards within a hard budget constraint, with the results publicly available, especially to parents and school managers. Similar strengthening of accountability mechanisms, including in the accreditation process, would also be needed at the tertiary level. Improved accountability mechanisms, combined with the proposed funding mechanism, would be a powerful tool for ensuring that decentralization reinforces national education goals, and that disparities across districts in education funding and achievement are monitored and corrective action is taken.

(f) *Intensified efforts to ensure equal opportunities*, especially for Roma children at the primary and secondary levels and for all students at the tertiary level. These efforts could include *using opportunities within the school consolidation program to provide Roma children with greater access to education in an integrated setting*, head-start pre-school programs, and other interventions specifically targeted for the Roma. For all students, greater equity could be achieved by *correcting the apparent wide geographical disparities in educational spending, as well as reforming the process and content of testing and admissions* at the secondary and tertiary levels. Student loans and need-based scholarships will become increasingly important at the tertiary level as the use of tuition expands.

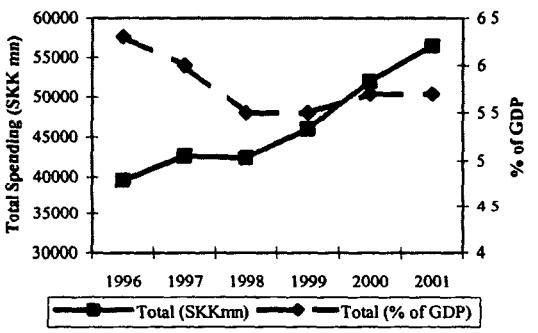
58. *The above agenda outlines steps to increase the relevance and quality of the education system, as well as its efficiency and equity, within tight resource constraints,* mainly by refocusing resources that are already being used. The consolidation and reorientation at the

primary and secondary level would free up resources for quality improvements, as would tuition at the tertiary level. The proposed funding mechanisms, combined with appropriate school-level autonomy, would give schools more flexibility to use resources to raise quality, and to adjust to changing needs, while the stronger accountability mechanisms proposed would ensure that this autonomy is used effectively to support the country's objectives in education. *By containing the overall use of public resources, and achieving a better link between the education system and the country's skill needs, the proposed reforms would contribute to the country's strategic objectives of growth, employment, and macroeconomic stability.* Such reforms, however, cannot be carried out by the stroke of a pen. Careful analysis and design work will be required to develop specific reform strategies and policies, to strengthen the institutions needed to implement them, and to build a consensus behind them. Consequently, *a critical early step in the reform process would be to designate a highly qualified team to take the lead in this effort.*

Health

59. Despite more than a decade of frequent and continuing reforms, and despite some improvements in the Slovak Republic's health indicators, health care remains beset by serious problems. *First, the health care system does not appear to be financially sustainable.* Demands on the system have risen rapidly (see Figure 2), bringing public spending to levels that are high compared to other CEECs and to the country's income level. The payroll tax rate for health (14 percent) is the highest in the region, yet the system runs persistent deficits, reflecting a very broad benefit package, unconstrained demands, inadequate revenue growth, and inefficiencies in the provision of care. For example, between 1990 and 1999, hospital admission rates rose by 18 percent, and per capita outpatient visits by 20 percent. Efforts to contain public spending have resulted in widespread formal and informal private payments, as well as in recurrent, large payment arrears throughout the system. Substantial infusions of extrabudgetary privatization revenues have been used to reduce the levels of debt from time to time, but the underlying imbalances that caused them remain, with system-wide arrears approaching 2 percent of GDP by March 2002. The country's multiple health insurance companies may only add to the problems by increasing administrative costs and fragmentation.

Figure 2: Public Spending on Health



[Source: MoF]

60. Second, *the existing health infrastructure continues to rely heavily on relatively costly, input-intensive approaches,* with too much emphasis on costly in-patient care and specialist physicians. Little progress has been made in realizing the substantial scope for improved effectiveness and efficiency through less intensive input use and a shift toward more cost-effective preventive and outpatient approaches. The incentives in the system do not appear adequate to reduce overstaffing and excess numbers of hospital beds and facilities. *Unsurprisingly, there appears to be widespread dissatisfaction with the health care system both among patients and among health care providers,* with concerns ranging from declining quality, denial of service, and rising informal payments, to low salaries for medical personnel. Surveys

have shown that *more than half of households and public officials viewed the health care system as having "very widespread" corruption*, the highest level of perceived corruption of any public sector activity.

61. *Without substantial reform, these problems are only likely to get worse:* demands on the system will rise as incomes rise, yet resources will become more constrained as the numbers of employees, the system's main contributors, decline relative to the elderly, whose health care costs are much (some 2.5 times) higher than those of the rest of the population. Over time, these problems are likely to compromise the quality of health care, particularly in the vitally important and cost-effective areas of disease prevention and health promotion, and to result in an erosion of the health of the population. While there are no ready-made solutions, the most productive areas for short- and medium-term action and reforms include the following:

(a) *Containing the excess demand inherent in the system* by narrowing the scope of the benefit package, tightening the link between contributions and benefits, and increasing cost sharing by consumers, with safeguards for those with low incomes.

(b) *Reforming the health financing mechanism,* to make it more efficient, to improve collection compliance, and to broaden its revenue base. This would include *consolidation of the health insurance companies into a single payer system, integrating collection of health insurance payments with other social contributions*, improving collection compliance, and shifting responsibility for funding a larger share of the non-contributing participants from the payroll tax to general taxation.

(c) *Increasing the efficiency of the provider network, reducing overstaffing and excess hospital beds.* A provider network rationalization plan should be designed and implemented to reduce overstaffing and excess capacity. *Improving provider payment mechanisms and other health system incentives could further help.* A range of mixed provider payment systems could be considered, preferably *incorporating a "money follows the patient" approach.* In parallel with these measures, and a tighter accountability mechanism discussed below, providers will need the autonomy and the management tools and skills to respond effectively to changes in the incentive structure.

(d) *Ensuring that the system has adequate incentives and funding for essential public health functions*, including cost effective programs to prevent sickness and promote good health practices.

(e) *Protecting access and equity* for all groups in the country, but with particular emphasis on meeting the needs of the Roma. This community has greater health problems than the general population, and less access to health care.

(f) *Strengthening the institutional framework* both to design and implement a systematic reform program and to better manage the health system. This would include: professional and technical capacities for policy and program analysis; the

necessary information systems; and the mechanisms for holding a more decentralized, autonomous system of providers accountable for quality standards and cost-effectiveness.

62. Reforms in the areas outlined above should serve to make the health care system more effective in meeting the needs of the people while containing its cost. Such reforms would contribute directly to the government's strategic objective of macroeconomic stability by reducing the pressure of rising expenditure. However, while many countries share the symptoms afflicting the health system, worldwide experience suggests that this does not make these symptoms easier to diagnose and cure. *A first priority therefore would be to establish a team to lead this reform effort* and develop and give direction to the institutional framework discussed above.

Social Protection

63. The Slovak Republic's spending on social protection programs has been fairly stable as a share of GDP in recent years, and (at 13.1 percent of GDP or nearly one-third of public spending) is around the CEEC average. But these aggregate numbers mask serious underlying problems, as well as some unrealized opportunities to stimulate growth and employment. First, despite significant reforms enacted in May 2002, *the PAYGO pension system faces unsustainable deficits as the demographic shift already under way inexorably reduces the numbers of contributors while increasing the numbers of pensioners.* A deeper reform of the pension system is therefore a high priority, not only to secure macroeconomic stability, but also to ensure adequate pensions for future generations, as well as opening some possibility for reducing the payroll tax.

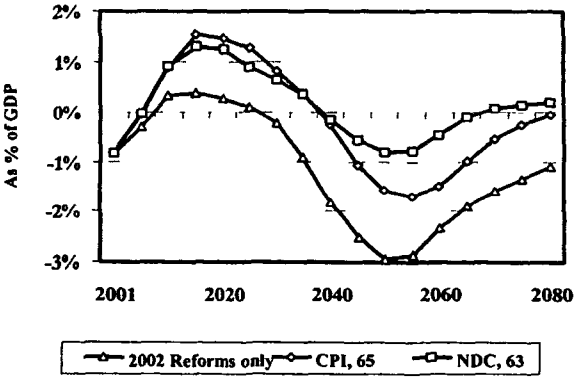
64. Second, among *Social Assistance programs, cash assistance for the unemployed and support for the disabled have grown exceptionally rapidly* in recent years and need to be carefully reviewed. While the cash assistance program, in concert with other components of social protection, has helped the country reduce poverty and deal with rising unemployment, *the level and structure of benefits generate major work disincentives and risk creating a "poverty trap."* Third, the surplus now being generated in the sickness insurance fund provides an opportunity to reduce the payroll tax, especially if combined with tighter spending control. Fourth, several other features of the social protection system, some of them relatively new, should be carefully reassessed to identify ways to ensure that they are cost-effective and well targeted to assist the poor. These features include the active labor market programs (ALMPs) administered by the National Labor Office, the child allowances recently made available to all parents regardless of income, the subsidies for spa care, and the recently established housing allowance.

65. The Slovak Republic's social protection system is comprehensive and complex. It not only uses a large share of the country's public resources, but also plays a vital role in reducing poverty and securing the welfare of the people. In considering improvements to such a system, *it is important that reforms be based on sound technical analysis within a holistic view of the relationships among the programs and their impact on the people, especially the poor.* A starting point in developing such a reform strategy would be to *designate a highly qualified team responsible for coordinating the technical analysis and consensus building needed to design the*

reform program and to strengthen the institutions to manage it subsequently. This report cannot substitute for the detailed design work such a reform requires; rather, it points to what appear to be the main problem areas and options for significant reforms, as summarized below.

66. In ***pensions***, *the most critical reform needed to secure the system's long-run financial viability is an increase in the retirement age to 65* (see "CPI, 65" line in Figure 3, compared to the "2002 Reforms only" line). Careful consideration should also be given to further tightening the link between benefits and contributions by further modifications of the benefit formula, which is still quite redistributive, even after the recent reform. This could include either a modification of the current Defined Benefit formula, or the adoption of a Notional Defined Contribution approach which would generate more stable fiscal outcomes as well as a tighter link between benefits and contributions (the "NDC, 63" line in Figure 3). Other desirable reforms of the PAYGO system include measures to improve contribution compliance, especially from the self-employed; transparent accounting, rigorous assessment, and possible phasing out, of some of the "non-system" benefits (such as accrual of pension rights by university students), and full state budget funding of those "non-system" benefits that remain; and removal of the recent provision allowing parents to reduce their pension contribution by 0.5 percent per child. Any savings to the pension fund arising from these reforms could be passed on to participants as lower payroll taxes.

Figure 3. Balance of PAYGO System, Three Mono-Pillar Reform Scenarios



67. While these reforms to the first pillar (the PAYGO system) are being launched, *the technical work for a mandatory, fully funded second pillar should be completed.* If the first pillar is financially sound, introducing a second pillar offers scope for gradual increases in benefits (as a percent of gross wages) over time. However, *if the first pillar is not sound, the transition costs involved in introducing the second pillar will only make the pension system less sustainable.* This is why it is critically important to secure adequate reforms of the first pillar. In designing the second pillar, options regarding its size, phase-in period, and switching age should be considered, and *the timing phased to take advantage of the Slovak Republic's incipient access to the EU's increasingly integrated capital markets, or even better to the euro-zone.* At the same time, institutional and administrative arrangements should be put in place to manage the reformed system, including the regulatory and legal framework for the existing private, voluntary third pillar, as well as the mandatory second pillar.

68. In ***Social Assistance***, there is a need to *contain the growth of spending on cash assistance for the unemployed and to reduce its work disincentives.* This can be done through: (i) *reductions in the benefit levels* (to widen the gap between benefits and average wages) by adjusting benefits to reflect regional cost of living differentials (or calculating them excluding Bratislava) and/or reducing the per child allotment as the number of children rises; combined with (ii) adjustments in the benefit structure to *"make employment pay"* (mainly by reducing the rate of withdrawal of benefits as recipients earn income, strictly enforcing activity tests, and

developing more effective ones, possibly linked to ALMPs). Strengthening the capacity of Social Assistance staff to conduct activity testing and to work effectively with the Roma could also be important. In addition, the programs to assist the disabled should be examined to determine if the recent rapid increase in spending is justified.

69. In ***sickness insurance***, there is an opportunity to return the surplus currently being generated to participants by *reducing the payroll tax (possibly by as much as 2 percent),* and to contain future pressure on spending by having employers (instead of the fund) pay for the first few days of sick leave. In addition, given the potential for fraud and abuse, consideration should be given to ending the participation of the self-employed in sickness insurance. For ***unemployment insurance***, *active labor market programs should be kept under close review and rigorously assessed to ensure their cost-effectiveness* and to identify ways in which they can *work in tandem with Social Assistance* to move people off the welfare rolls.

70. For ***other state social benefits***, consideration should be given to *reversing the recent changes in the child allowance* by subjecting recipients again to an income test. Various options for modifying the level and structure of the benefit could also be considered. If the universal child allowance is retained for parents of all income levels, it should be subject to the income tax. Spending to subsidize *spa care* could be reassessed to determine if there are not more effective uses of funds to improve social protection (e.g., to fund tapering of the withdrawal of social assistance benefits as recipients earn income).

71. For ***housing subsidies***, consideration should be given to *terminating the program*, relying on Social Assistance to meet the needs of the poor in this area. If needed as a transition, measures such as targeted lifeline tariffs for low-income customers should be considered.

Revenue Rebalancing and Consolidation

72. On the revenue side, given the steep tax reduction implemented in the last four years, the time has come to place top priority on fiscal consolidation and to postpone any further *reduction in total revenue until fiscal consolidation objectives are accomplished.* There is, however, a broad scope for important changes in the structure of revenues.

73. Most significantly, the expenditure reform strategies discussed above would open up opportunities for *rebalancing the revenue base by significantly reducing reliance on the payroll tax. The largest opportunity lies in health insurance*, where the 14 percent payroll tax paid by employees generates some 70 percent of health insurance revenues, while the government payments for the 60 percent of the population that does not contribute provide less than 30 percent of revenues. The employed workers therefore heavily cross-subsidize the rest of the population, and the link between their insurance contribution and their benefits is correspondingly weakened. This could be corrected by shifting more of the burden of funding the non-contributors from the payroll tax to general taxation. Rough calculations indicate a payroll tax on the order of 7 percent would generate enough revenue to cover the insurance costs for the participant.

74. *Reforming sickness insurance* opens another opportunity to reduce the payroll tax: here, a 4.8 percent payroll tax has been generating a surplus equivalent to 2 percent of payroll.

Tightening control on spending of this fund by having employers take on the burden of financing the first few days of sick leave would help contain spending levels and lock in the surplus. The payroll tax could then be safely reduced by as much as 2 percent.

75. Finally, *some of the pension reforms proposed may provide some scope for further reducing payroll taxes.* In particular the transparent assessment of the full costs of "non-system benefits" (primarily accrual of pension rights by students and those on maternity leave, and pension increments to top up pensions to a socially acceptable minimum), phasing out those not justified, and shifting the full cost of the rest to the budget, could result in savings to the pension fund that could be passed on as payroll tax deductions.

76. The reduction of labor taxes should be *offset by an expansion of the tax base of both the CIT and the PIT.* On the CIT side, the proposed improvements in the business climate could pave the way for *scaling back the currently excessive tax incentives provided to investors*, as a result of the destructive tax competition waged by Visegrad countries. In the Slovak case, the process started in 1998 when the government offered a tax credit allowing exemptions from corporate income tax for particular activities. Subsequently, the incentive package was amended several times, with the last changes being introduced in December 2001. The most recent innovation has been the almost indiscriminate promotion of industrial parks (the state covers 70 percent of the development of industrial parks by the municipalities).

77. The prospect of EU Accession offers a golden opportunity to break the vicious circle. The Slovak authorities would be well advised *to support any initiative taken in the context of the negotiations of the competition chapter of the accession treaties to harmonize tax incentives at the lowest possible level.* Furthermore, without denying the advantages that industrial zones can provide, it would be in the country's own interest to *subject any incentive for the creation of such zone to two market tests: (i) the demonstrated commitment of an interested investor; and (ii) the presence of a majority private sector stake in the industrial zone itself.*

78. Similarly, *those categories of income currently exempted from PIT should be brought into the tax base.* This concerns in particular pensions (which would need to be appropriately rebased), and child allowances, if they continue to be available to all parents. *Some indirect taxes could also be raised.* Increasing excises for beer and tobacco and unifying VAT tax rates at the current top level would be the most relevant measures in this area. *There is finally room to expand non-tax revenues*, particularly those linked to revenues from government participation in gas and electricity companies (including the special levy proposed above), as the planned increase in regulated prices would produce profit windfalls.

79. Finally, current and future inflows of privatization receipts from abroad should be used to retire *foreign rather than domestic debt.* Not only is this needed to keep such inflows from spilling over into excessive domestic demand; such an approach would also be consistent with a strategy to optimize the currency structure of public debt and to deepen the domestic debt market. At present 52 percent of public debt is in foreign currency, which is relatively high, and about one-third of that foreign debt is in currencies other than the euro, which may be unduly risky given the country's prospect of joining ERM-2 in the not too distant future. On the other hand, the domestic debt market is under-developed, and lacks predictability and transparency: there is, for instance, no firm issuance program, making it difficult for market participants in turn

to plan and manage their own cash flows. To overcome this deficiency, the government would be well advised to undertake the following:

(a) Integrate cash and debt management within the Ministry of Finance (international experience would seem to advise against delegating that task to a separate debt management agency in circumstances where oversight capacities are weak)

(b) Rely primarily on regular, non-discretionary debt issuances designed to create liquid benchmarks spread along the yield curve

(c) Develop an asset/liability management strategy in line with best practices among EU members and develop the attendant risk management systems.

LABOR MARKET REFORM

80. *Reducing unemployment is perhaps the clearest mandate emanating from the recent elections and is consequently a priority for the new government.* The recent OECD country report lays out a comprehensive agenda in this regard; this one can therefore be brief.

81. Some of the labor demand-side measures have already been mentioned. In particular, the discussion above highlighted the substantial scope *to reduce labor costs by reducing payroll taxes.* This in turn would require the parallel transfer of the costs of the social welfare components of pensions and health insurance from the social insurance system to general taxation.

82. *Increased flexibility in labor relations and wage setting mechanisms are a second way to boost labor demand.* In this regard, it is strongly recommended to put an end to the deliberate policy of raising the minimum wages more rapidly than other wages, as part of *a broader policy to discard the minimum wage as an instrument of incomes policy* (while continuing to see it as an instrument for worker protection). As presented in the PEP, the current approach intends to "gradually increase the proportion of the minimum to the average wage level." While this policy may encourage some extra workers to participate, it is also sure to reduce labor demand, particularly at the low end of the wage scale. It would also be desirable to limit the extension of regional or sectoral collective bargaining agreements only to those firms that participated in the negotiations. The extension to firms not involved may result in wage awards that are not in line with improvements in productivity. Along these lines, the *decentralization of wage bargaining will enable wage agreements to reflect more closely productivity conditions at the firm level.*

83. *Furthermore, the easing of many of the restrictive regulations currently embedded in the new labor code could facilitate job creation and the reallocation of the labor force following the structural changes in the enterprise sector.* This would include increasing the flexibility of regulations limiting working hours, and protecting employment in general, and reducing the labor unions' role in the management of personnel issues. Instead, regulations should be modified so as to improve flexibility, reform provisions for part time employment, reduce red tape for the creation of SMEs, and soften some of the most protective employment provisions of the labor code for SMEs.

84. On the supply side of the labor market, it will also be necessary, as discussed above, to encourage labor force participation by revising the social assistance benefit levels and structure, to widen the gap with average wages and to increase incentives to move from welfare to work. Labor force participation would benefit from making the activity tests for Social Assistance more effective and tapering the withdrawal of benefits as recipients find gainful employment. In the longer term, efforts should be aimed at adapting the supply of human capital to the new market requirements. Promoting general as opposed to vocational secondary education and gradually expanding enrollment at the tertiary level, as recommended above, would contribute to this end.

GOVERNANCE

85. The government's success in designing and implementing a reform program on the lines discussed in this report will depend fundamentally on its capacity to strengthen the institutional framework in which those policies are conceived, decided upon, and executed. While there are many critical issues and areas for action for improving the institutions of governance, this report focuses primarily on *public sector management* issues, the implications for *the decentralization process* currently under way, and *reforms of the justice sector*, three areas where stronger institutions are strategically critical if the public and private sectors are to operate with efficiency and integrity.

Public Sector Management

86. How successful the government will be in its fiscal consolidation efforts, and in its broader efforts to reform the economy to prepare for EU accession, will depend critically on progress in building the institutions and capacities needed to design reforms and manage them, and in improving the tools of fiscal management and program assessment. While there are a number of important measures that can and should be taken in the short term (especially reducing enterprise subsidies and starting to raise the retirement age), most of the important measures for containing expenditures in a sustainable way, based on sound program reforms, will require a thorough, comprehensive review of the overall expenditure program. This should not be a one-shot exercise, but should be a continuous process to identify reforms of the main expenditure programs, including a careful assessment (and subsequent monitoring) of the impact of the reforms on the poor, especially the Roma. The process will also require a parallel strengthening of institutions to manage programs following their reform. This process will involve choices over time about what the public sector should do, how much it should do, and how it can do it most effectively. Many of these choices will be politically sensitive, and thus an important part of the effort would be to develop an understanding of and a political consensus for the need for such reforms.

87. **Public Expenditure Management.** Transforming the medium term budgeting and program budgeting frameworks into effective fiscal planning tools, improving the quality of underlying financial and performance information, and enhancing systems integrity are thus all important goals. It is especially important to ensure that the basic fiscal accounts are accurate and timely, and are maintained in ways that are consistent and well understood across line and core agencies. Furthermore, it will be important to *consolidate the recent decentralization to ensure that capacities and accountability mechanisms are in place before moving to the next*

phase of devolution. Finally, in responding to this challenge, the country needs to *avoid the temptation of paper reforms*. Not only are they pointless, but reforms that exist only on paper are also potentially dangerous: they create the illusion that problems are being corrected, while pushing actual practices into a legal and administrative limbo where they become harder to regulate.

88. This report emphasizes the critical need for the Slovak Republic to develop the institutions, capacities, and processes that will generate the objective assessments of program performance and reforms needed for continuous improvements in effectiveness and efficiency. This would call for the development of analytical capacities in core and line agencies alike, including continued improvements in the measurement and comprehensiveness of budget accounts, the development of a more formal and systematic medium-term approach to fiscal programming in both the Ministry of Finance and the line ministries, and a move toward greater performance orientation in budgeting, as well as the establishment of periodic, representative household budget surveys. It would also call for the designation of highly qualified teams to coordinate the detailed design work needed to translate ideas for reform into workable strategies for implementation.

89. **Medium Term Budget Framework.** To assist in their efforts towards fiscal consolidation, a growing number of governments are finding it *useful to bind themselves to medium-term budget rules*. The Slovak Republic has also made a formal commitment to medium-term budgeting (most recently in the new Act on Budgetary Rules), but the actual move toward multi-year budget frameworks has hardly begun. Three-year projections of aggregate revenues and expenditures are now being produced (including those used as a basis for the annual pre-accession economic program that the country presents to the EU). In practice these forecasts have remained a peripheral activity to budget preparation and execution. One illustration of this phenomenon is the wide gap between the target presented in the 2001 PEP for general government expenditure in 2002 and the current official projection (37 percent of GDP versus 40.6 percent of GDP). Perhaps the best way to institutionalize a medium term budgeting framework would be to elevate it to a formal political commitment binding the government to the general public.

90. **Program Budgeting.** Expenditure rationalization would also be easier if the budget process generated a better sense not only of where public monies are spent but also of what is being delivered and achieved with these monies. The introduction of program budgeting, with that objective in mind, appears to be proceeding in a well-structured manner. Nevertheless, concerns have been raised as to whether units in the line ministries fully understand the changes implied by program budgeting, or whether they simply see it as a set of forms and information requirements imposed from outside. Program budgeting will successfully assist resource allocation only where *its goals* are well understood, so that government operations can be assessed (or at least challenged) in terms of their cost as well as their conformity with stated policies and objectives; and where *its procedures* are seen to facilitate the running of the line agencies themselves. One of the implications of this is that progress in budget methodologies needs to rest firmly on the strengthening of analytical capacities within line ministries.

91. At the same time, *capacities and instruments to assess program impact and effectiveness* need to be put in place, *including a well-designed system of periodic household income and*

expenditure surveys. This can be a key tool in assessing the impact of a broad range of programs and policies, especially their impact on the poor.

92. **Performance and Financial Information.** The possibility of making such productive use of the program budgeting framework will therefore *depend critically on the quality and reliability of the underlying financial and information systems.* Unfortunately, the lack of an integrated financial information system to bring together the Ministry of Finance, the line ministries, the spending units, the National Bank of Slovakia (NBS) and the NKU creates problems of untimely, unshared, and inaccurate information. *The main justification and focus of the proposed Treasury reform ought to be to remedy these deficiencies.* The reasons for wanting to transfer payment functions away from the Central Bank as envisaged in the Treasury Act are less clear, and prima facie, less urgent with regard to the fiscal consolidation priorities outlined above. Worse, this initiative is proceeding on an unrealistic implementation plan, threatening to leave that critical function in the same legal and administrative limbo that now surrounds debt management operations (following a similarly hasty reform). There is therefore an urgent need to (i) recalibrate and prioritize Treasury reform objectives to serve the requirements of the government's overall fiscal strategy; and (ii) clarify the responsibilities (transitional responsibilities, if need be) so that debt management and Treasury operations do not proceed in a legal vacuum.

93. **Systems Integrity.** *The integrity of budget execution systems appears to have been compromised more often by weaknesses in procurement and audit* than by problems with Treasury operations per se. Weak points in the public financial accountability system are: (i) defective procurement practices; (ii) weak follow-up and remedial action on significant audit findings; (iii) weak accountability arrangements for local government units; and (iv) an administrative culture that tolerates corrupt acts.

94. A blueprint was recently submitted to the government *on how to improve the transparency and efficiency of procurement.* Key next steps should include: (i) establishing permanent procurement committees within contracting authorities that are responsible for decision making and for providing oversight and evaluation committees to deal with the bidding process; (ii) developing a formal code of ethics for government employees to improve their accountability in procurement; and (iii) completing procurement guidelines to cover non-public tendering procedures as well as procurement of consultants and updating of standard bidding documents. It is also recommended that the role of the NKU in conducting procurement audits of contracting authorities at regular intervals be enhanced and its reports made public.

95. At present, the *existing audit* (carried out by the NKU and the Ministry of Finance) *is essentially external in nature* and directed primarily at fault-finding rather than at assessing the adequacy of systems. Modern concepts of financial control, which have not made much headway in the Slovak public sector, locate the prime responsibility for financial control with the management of the entity concerned. If the country wishes to achieve strong public financial management, it has to locate the essential controls (and accountability) at the entity level. NKU's external audit could then focus on whether the internal control systems established by management are adequate and are working properly. That function would be more effectively discharged if the Ministry of Finance were mandated to follow up with line ministries on defects identified at audit and to report to the legislature on the status of remedial actions taken.

Decentralization

96. *The ongoing decentralization may potentially complicate the task of putting public finances on a sound footing.* All in all, about 4.5 percent of GDP in new responsibilities is to be transferred to the existing 2,886 municipalities and to eight newly created regions. Unless measures are taken to consolidate the process, the risk is that the resulting greater fragmentation of public services might make it all the more difficult to realize the existing potentials for economies of scale, while further bloating the bureaucracy by duplication and fragmentation. There is indeed little empirical evidence that fledgling decentralized authorities would have the needed administrative capacity or political mettle, or that they would operate in an accountability framework that would maximize the public good. In the face of hard budget constraints, what is more likely to be weakened is the quality and accessibility of services for large segments of the population (especially those with little clout, like the Roma).

97. For the immediate future therefore, the priority is to *consolidate the present phase of decentralization* --before planning (or executing) new advances -- by:

(a) *Clarifying the respective roles and responsibilities* (including in terms of assets and liabilities) of the regional and district levels of the national government on the one hand and of the municipalities and newly created regions on the other.

(b) *Actually creating regional administrations.* This essential piece of the institutional framework exists only on paper. To facilitate transitions and avoid duplications, it would be preferable to keep the new self-government services, and the remnants of the regional office of the national government under one single, integrated administrative structure.

(c) *Overcoming the disadvantages of municipal fragmentation.* As long as this fragmentation persists, the district offices will have a critical role to play in stimulating intermunicipal cooperation and overseeing and backstopping weaker and smaller municipalities. That capacity should be maintained.

(d) *Funding newly transferred responsibilities through itemized, tied decentralization subsidies.* This current arrangement is appropriate to a situation in which administrative capacities and accountability mechanisms are either weak (municipalities) or, at best, untested (regions). Only over time will it be safe to move towards untied grants as local implementation and fiscal capacities strengthen and the need for central oversight lessens accordingly.

Justice Sector Reform

98. Modernizing the justice sector is critical for accelerating and maintaining economic growth, ensuring equitable access for vulnerable groups, and increasing social cohesion and stability. For example, the formal bankruptcy procedures that are so important for efficient enterprise restructuring may not become truly dependable until the structural deficiencies in the judiciary system have been corrected. Unfortunately, despite initial reforms over the last decade, the judiciary has earned a reputation for being slow, expensive, and corrupt. Indeed, surveys indicate that the judiciary comes second only to health care in terms of perceived corruption.

99. To remedy this situation, the country should give priority to (i) refocusing the Supreme Court on its core mandate; (ii) strengthening the management and policy capacity in the Ministry of Justice; (iii) creating a body of professional court administrators; (iv) rolling out the modernized case management system throughout the judiciary; (v) stepping up the investigation and prosecution of corrupt judges; (vi) strengthening the regulatory bodies of the legal profession and separating this role from that of advocacy; and (vii) enhancing client protection.

MACROECONOMIC OUTLOOK AND WELFARE IMPACT

100. The proposed policy package should help the economy converge towards EU-levels of income and reduce unemployment. In itself, the prospect of a now imminent EU accession unquestionably improves the economy's outlook. While training their sights on that target, it will be important for all to keep in mind that it is *the implementation of EU policies*, more than *membership per se*, that will determine the pace of the hoped-for convergence. With the measures proposed above to invigorate the supply side, output growth should continue to outpace average EU growth, expanding at a rate of 3.5-4 percent in 2003 and accelerating to an average 4.7 percent over the next four years. Action will also be needed on the demand side for such a scenario to materialize. Timely fiscal consolidation will be central if private sector demand is to continue to expand apace when privatization inflows subside -- without threatening external stability. Bringing down the fiscal deficit to 2.5 percent of GDP over the medium term will help that scenario come about. This would allow combining robust private investment with a steady lowering of the external current account deficit, in a first phase below 5 percent of GDP by 2007. With demand under control, inflation would bounce back only briefly to some 7 percent in 2003 due to adjustments in utility prices before settling back down towards 3-4 percent.

101. The measures proposed in this report to secure sustained growth and broader-based employment, especially in the lower-wage, lower-skill end of the job spectrum, should also set the economy on a path to reduce poverty. Of particular importance for poverty reduction will be:

- Measures to ensure the expansion of a diverse and efficient enterprise sector, able to compete in world markets and generate productive jobs
- Labor market reforms that would reduce rigidities, especially those that tend to price low-wage labor out of the market
- Reforms in social assistance and other components of the social protection system that will ease the transition of recipients from welfare to work, as well as make the system more sustainable
- Reductions in payroll taxes to reduce their impact on discouraging growth and employment
- Implementation of decentralization with a view to securing equal access to quality basic health and education services for all
- Reforms in education that will ensure that those entering the labor market have the skills needed to function effectively in a dynamic labor market
- Pension reforms that will help ensure more secure and more adequate benefits for future generations of retirees
- Improvements in the capacities and instruments for the analysis of program and policy impacts in general, and poverty in particular.

102. On the other hand, some of the policies discussed above may unfortunately hurt the lower income group of the population. This would be the case particularly with the adoption of the EU's Common Agricultural Policy (through its impact on food prices), and with the necessary adjustment of energy tariffs. A key element in mitigating such negative effects would be to adjust social assistance benefits at regular intervals in the light of well-designed, periodic household budget and expenditure surveys.

CONCLUSIONS

103. The Slovak Republic's external current account and fiscal deficits (net of privatization receipts) are unsustainably high (at about 8 percent of GDP in 2002), despite some recent declines. With a capital account surplus of perhaps 20 percent of GDP this year, the Slovak Republic may not find it particularly difficult to finance these deficits, but this favorable situation will not last. Furthermore, through its impact on the real exchange rate, this policy mix is undermining the employability of large segments of the population (particularly those with low skill levels) and will ultimately choke growth (projected at 4 percent for 2002). While much policy attention has gone to stimulating investment, future growth will also depend on raising the employment rate, currently one of the lowest among the CEECs.

104. This report lays out the broad thrust of a policy strategy to bolster the recovery and bring the economy towards convergence with the EU. This strategy consists of three key elements:

(a) *Continued trade, finance, and enterprise reform* to complete the structural transformation of the economy and align it with the EU framework

(b) *Fiscal consolidation*, focusing on cutting back expenditure and stabilizing revenues, while redirecting revenue and expenditure policies to become more fully supportive of growth and employment objectives

(c) *Labor market reform*, directed at enhancing labor market flexibility by relaxing legal provisions on working arrangements (such as part-time work, self-employment, and fixed term contracts), by decentralizing collective bargaining, and discarding the minimum wage as an instrument of incomes policy, and by reforming the social assistance system.

105. The ultimate success of the policy reforms outlined in this report will depend to a great extent on *the government's capacity to strengthen the institutional framework in which those policies are conceived, decided upon, and executed.* Three priorities have been highlighted: (i) the reform of public expenditure management systems and practices needed to support a growth-oriented fiscal strategy; (ii) the consolidation of the recent decentralization moves as a prerequisite for further devolution, and (iii) a much overdue overhaul of the judiciary system.