

## Economic Survey of Slovak Republic, 2005

### Summary

Sound macroeconomic policy, assertive product, capital and labour market liberalisation, and fundamental tax and welfare reform have transformed the Slovak business environment in recent years. Foreign direct investment (FDI) has responded particularly well, becoming the prime engine of capacity and productivity growth, and helping to put the economy on a strong and well-balanced growth path.

However, unemployment remains very high and many economic activities in the non-tradable sector are under-developed and less productive than those in the FDI sector. To broaden the basis of growth, four main challenges must be addressed:

#### *Ensuring a smooth path to euro area accession*

Recent fiscal and inflation outcomes have been good, making the government's goal of meeting all Maastricht convergence criteria by 2007 credible. However, if an excessive pace of exchange rate appreciation were to resume, monetary policy would again face a dilemma between inflation and competitiveness objectives. Hence, it may be desirable to move towards an exchange rate anchor early, making sure that exchange rate stability is underpinned by a consistent macroeconomic policy mix. To ensure that the overall convergence strategy remains credible, close adherence to planned expenditure cuts will be essential, together with continued structural reforms. Moreover, further consolidation will be required if additional fiscal risks materialise.

**Have reforms brought euro accession closer?**

**Is more action needed to keep convergence on track?**

**Have tax and labour market reforms done enough to create jobs?**

**Does the education system equip pupils for working life?**

**Should more be done to encourage economy-wide innovation?**

**Is more action needed to improve the business climate?**

**What can be done to improve the effectiveness and efficiency of the public sector?**

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*This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of the Slovak Republic. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

***Boosting job creation and improving labour mobility***

Major reforms have enhanced the flexibility of the labour market and have improved incentives for the unemployed to seek work. Yet, although recent employment growth has been positive, long-term structural unemployment remains high. In order to stimulate the creation of jobs that require low skill levels, costs of low paid labour should be significantly reduced, either by cutting employers' social security contributions for low-wage workers, or by reducing the minimum wage. Housing market rigidities also contribute to high unemployment by repressing labour mobility. New policies should facilitate a larger role for the private sector – particularly in the rental housing market – and public support for housing should be reformed.

***Improving conditions for innovation and growth***

Thanks to high FDI inflows, modern manufacturing and business processes have diffused rapidly throughout many sectors of the economy. However, to encourage more widespread spill-overs of productivity, innovation policies should focus on continuing to foster an efficient business environment for dynamic enterprise creation and competition. The major deficiencies relate to accountability problems in the legal system, still wide-spread corruption, and some remaining regulatory issues. In addition, the education system is not sufficiently preparing Slovakia's youth, and low-qualification adults, for the modern business environment and substantial reforms are needed in the primary, secondary, tertiary, and life-long education systems.

***Building a modern public sector***

The public sector has a critical role to play in providing the economy with a reliable legal and regulatory framework, and adequate core services. To do this better in the context of pressures for expenditure restraint, the government should make increased use of strategic priority setting and results-oriented budgeting. It should also accelerate the introduction of performance-based personnel management and the use of market mechanisms in the provision of services. Decentralisation can be an important vehicle in modernising the public sector if risks of excessive fragmentation of service supply and of overspending and corruption are minimised. ■

**Have reforms brought euro accession closer?**

Slovakia's combination of sound macroeconomic policies, comprehensive tax and social welfare reform, and new regulations for the product, capital and labour markets, has resulted in an acceleration of growth over the past five years and has increased the pace with which Slovakia is catching up to the living standards of wealthier nations. The coherence and consistency of the reforms, together with EU membership, has helped to convince large multi-national corporations that the Slovak economy is an attractive investment destination. The penetration of foreign direct investment (FDI) has been high, with business investment – particularly in the export-oriented manufacturing sector – becoming the prime engine of capacity and output growth. FDI has brought with it new technology and better business practices, many of which have now trickled down to domestic firms who have been forced to compete in the more dynamic business environment. Indeed, productivity gains have been most notable in those sectors that have seen significant FDI inflows and in those where competition is strongest. At the same time, interest rates, inflation, and the public deficit have been converging to European Union benchmarks, further enhancing the credibility of the reform agenda and increasingly facilitating the access of smaller firms to credit. Thanks to a robust increase in potential output, strong export and domestic demand over the past two years have faced no major supply constraints and the economy has remained on a balanced growth path of around 5% per year. Looking ahead, however, the extent of excess capacity in the economy is diminishing, suggesting possible risks for inflation.

Despite these impressive gains, it is clear that Slovakia is only part way through building a modern, flexible and diversified economy which provides entrepreneurial and employment opportunities to the entire population. Some policy areas – such as education and judicial reform – now stand out as the most significant elements of unfinished business. In order to consolidate the progress that has already been made, and to ensure the social and political sustainability of the reforms, a number of challenges must be addressed:

- The Maastricht criteria imply that Slovakia has a tightrope to walk in order to successfully adopt the

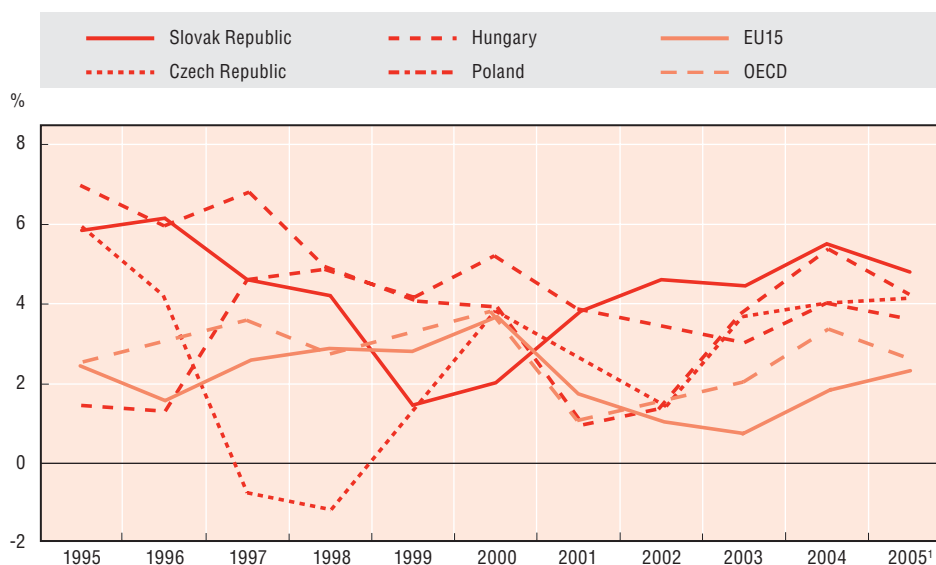
euro in January 2009 as planned. The impact of speculative capital flows is a potentially significant risk.

- Despite recent employment growth the employment rate is low and unemployment remains very high, particularly in the eastern regions and among those with low skill levels.
- The basis of growth remains relatively narrow. While multi-national firms receive significant government support, both in terms of financial incentives and assistance to fast-track administrative hurdles, small and medium-sized domestic firms are more reliant on local market conditions and on the local institutional framework and are therefore more vulnerable to shortcomings in the domestic business environment. As a result of these shortcomings, the innovative capacity of the economy seems weak outside the FDI-dominated sectors.
- The recent fiscal decentralisation adds to the already considerable challenge of delivering high quality public services at low cost. Inadequate spending management has led to inefficiencies and corruption, and to an insufficient use of market mechanisms in the provision of services. ■

### Is more action needed to keep convergence on track?

A primary objective of the government is adoption of the euro in 2009. This will involve achieving the Maastricht criteria for fiscal consolidation, low inflation, and exchange rate stability in the face of potential tensions between the inflation and competitiveness objectives. In recent months a number of positive economic outcomes have alleviated concerns about the challenges inherent in meeting these criteria: inflation outcomes for the first few months of the year were significantly lower than expected, easing concerns about inflation spill-over from much higher inflation rates last year; the fiscal deficit for 2004 was lower than projected; and the upward pressure on the koruna exchange rate eased. These outcomes make the government's goal of meeting all convergence criteria by 2007, followed by euro adoption in January 2009, increasingly credible. However, if the previously excessive pace of exchange rate appreciation returns, particularly at the same time as an over-heating of the economy, monetary policy would again face a dilemma between cutting interest rates to dampen excessive appreciation, and raising interest rates to slow the economy.

Figure 1. Real output growth



1. Projections.

Source: OECD, *Economic Outlook* No. 77.

Given the strong role of the exchange rate transmission channel for inflation, some appreciation of the nominal exchange rate would help to keep inflation low in the context of a strong domestic economy, and this would also be consistent with fundamental factors that are likely to warrant a gradual real appreciation of Slovakia's exchange rate. However, both in the lead-up to entering ERM-II, scheduled to take place sometime before mid-2006, and after ERM entry, policies should be oriented towards ensuring that the real exchange rate does remain in line with the economic fundamentals. In the context of strong capital flows this could be challenging. Since the current level of the exchange rate is seen as broadly sustainable, it may be desirable for Slovakia to seek early ERM-II entry in order to lock in these favourable conditions. However, continued credibility of the government's broader euro-entry strategy (including fiscal consolidation) would be crucial.

Slovakia has achieved significant expenditure consolidation over the past few years. As a result, the general government deficit of 3.3% of GDP for 2004 brings the Maastricht deficit ceiling of 3% within reach. However, there are a number of risks. One is an upward revision to the cost of pension reform after a greater number of people transferred to the second pillar pension scheme than was predicted. This concern has only in part been alleviated by recent changes to the Stability and Growth Pact, which considers taking into account, to some extent and for a limited period, the costs of pension reform. Other risks may stem from higher than projected health care costs, and from the political environment ahead of the 2006 election. *If some of these risks materialise further fiscal consolidation will be required.* Any procyclical loosening of fiscal policy at a time when the spare capacity of the economy is diminished would shift additional stabilisation burden onto monetary policy and raise the risk of a conversion to the euro at an over-valued exchange rate. *Moreover, if any signs of over-heating in the economy emerge, further fiscal consolidation would help to reduce demand pressure and improve sustainability.* ■

### **Have tax and labour market reforms done enough to create jobs?**

The Slovak government deserves significant credit for a range of reforms which have clearly enhanced the flexibility of the labour market and improved incentives for the unemployed to seek work. The

labour code has made working conditions more flexible and has eased the conditions under which workers can be laid off, thus providing a favourable background for job creation and job reallocation. As regards work incentives, tax and welfare reforms have significantly increased incentives for the unemployed to seek work. It is encouraging that in the past four years net employment creation has picked up, as the balance between job creation in growing activities and job losses in declining sectors has turned positive. More particularly, net employment creation in the private sector has accelerated in the past two years and dominated employment losses in declining and adjusting sectors. The unemployment rate remains nevertheless very high for the low-skilled and in the less advanced regions. Additional efforts will be needed to bring about a significant fall in unemployment.

Although the reforms to social security have increased the incentives for people to seek jobs, more needs to be done to increase the availability of jobs for those seeking them. To do this, *Slovakia should significantly reduce the costs of low-skilled labour. This could be achieved by reducing either the minimum wage or employers' social security contributions for low paid labour.* If the minimum wage is cut, the impact on net incomes could be mitigated by the government's proposal to introduce an earned income tax credit. Either of these proposals would help to boost job creation for low-skilled workers, who are the most abundant among the unemployed. *The fiscal cost of this should be funded through expenditure restraint in less urgent areas such as industrial and agricultural subsidies.*

Given very large regional differences in unemployment rates, current housing market conditions seem to pose a major obstacle to workforce mobility and, consequently, to the efficient functioning of the labour market. Although some steps have been taken to improve labour mobility, it remains almost impossible for an unemployed person to relocate and find affordable housing in a city where jobs are more plentiful. There is an urgent need for new policies that facilitate the role of the private sector in the housing market. In particular, *the civil code on tenant protection should be reviewed to improve the incentives for private sector supply on the rental market. The effective management of privatised multi-family housing should also be facilitated. Finally, the current system of subsidies for housing should be wound back, including bonuses for savings*

schemes, in order to increase housing allowances in the highest-cost regions to facilitate labour mobility. ■

## Does the education system equip pupils for working life?

Over the medium to long run, education and human capital accumulation have the potential not only to improve people's employment prospects, but also to contribute to higher productivity growth and to innovation. Yet there is evidence that the current education system is not sufficiently preparing Slovakia's youth for the modern business environment. *At the primary and secondary school level, there is an urgent need for a new curriculum, improved teaching methods, and policies to improve the learning outcomes of students from low socio-economic backgrounds.* The critical importance of better equipping all school pupils for their working life suggests that there may also be a case for allocating a greater proportion of total education expenditure towards primary and secondary schools. At the tertiary level, reform has recently been set back by tensions within the governing coalition, which led to the rejection of the Tertiary Education Funding Bill that would have introduced partial tuition fees. With this channel for motivating improvements in the quality of the universities closed (for the present) it becomes even more important that

*quality improvements in tertiary institutions be promoted through competition between existing universities, as well as entry by new high-quality universities, especially from abroad. Public funding mechanisms for universities should also support competition by replacing pre-determined budgetary allocations to universities with more contestable results-based funding, and by competitive research grants.* Finally, the need to update and upgrade the skills and competences of low skill adults is receiving insufficient attention, and *it is important that the responsibilities of the Ministry of Education and the Ministry of Labour and Social Affairs for addressing the learning needs of adults be strengthened.* ■

## Should more be done to encourage economy-wide innovation?

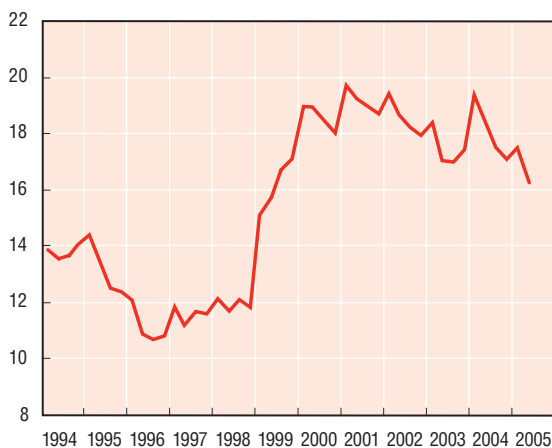
Productivity growth and the innovative capacity of the Slovak economy have been greatly aided by macro-economic stability, the opening of the economy and market liberalisation. Foreign direct investment (FDI) has played a particularly important role. Many sectors of the economy have now introduced manufacturing processes and business practices that make full use of the pre-existing stock of knowledge in the more industrialised economies. But other sectors continue to lag significantly behind the state of existing knowledge. *Innovation policies should facilitate the dissemination of global knowledge in a wider range of manufacturing and service sectors, rather than focusing primarily on extending the innovation frontier in a few selected fields. In addition, business innovation in domestically-owned firms and start-ups should be promoted by improved tax treatment of capital gains and by relaxing current restrictions that prevent pension funds from investing in venture capital and private equity funds.* ■

## Is more action needed to improve the business climate?

The Slovak government has made very significant progress in recent years to reduce unnecessary administrative burdens on businesses and to enhance competition in product markets. In addition, the comprehensive 2004 tax reform has significantly improved investment incentives. A deficit of reforms remains in the areas relating to the legal system, corruption, liberalisation of professional services and enforcement of the competition and regulatory

Figure 2. **The rate of unemployment<sup>1</sup>**

As per cent of labour force



1. Labour Force Survey measure.

Source: OECD, *Main Economic Indicators*.

policies. To address these concerns *the government should implement measures to improve the management capacity and lines of accountability for judicial sector outcomes, implement the already adopted measures to reduce corruption in the judicial system, and introduce additional changes to reduce corruption in the political system and in public procurement. The government should also ensure that the regulatory and competition authorities are vested with sufficient resources, and be as comprehensive as possible in further simplifying the relationship between the public administration and firms.* With respect to corruption, some good policies have been introduced, but politicians (at both the central and sub-central levels) should show more moral leadership and willingness to accept anti-corruption laws that are relevant to their own positions. *The parliament should adopt the proposed new Constitution Law that would reduce the immunity of members of Parliament and extend the authority of the Supreme Audit Office to regional and municipal governments. The Parliament has passed a law allowing the forfeiture of illegally acquired assets but further improvements are needed.* ■

### **What can be done to improve the effectiveness and efficiency of the public sector?**

The public sector has a critical role to play in supporting the economy through the provision of key public services, and by setting an effective and reliable legal and regulatory framework. However, to carry out these tasks well, additional modernisation of the public sector is required. To comply with the fiscal consolidation constraint, *public sector reform should rely on “strategic priority setting and results-oriented budgeting”.* This would help the government to allocate more resources to the key areas where they are currently insufficient, such as education, and make sure that resources are utilised in the service of clear policy objectives. Also, *the internal and external audit infrastructure should be reinforced* in order to better ensure the integrity of expenditure management and public procurement and reduce the risks of fraud and corruption.

An ambitious decentralisation has been launched, driven more by political objectives than economic efficiency considerations. It nevertheless offers opportunities for introducing service innovations, enhancing their responsiveness to needs, and reducing costs. To

build on this potential, however, authorities will need to overcome two structural shortcomings: the municipal structures are too fragmented to provide services at an adequate scale and quality, and sub-central fiscal institutions are not sufficiently well developed and integrated with the national fiscal management framework. Although it is too early to judge the effects of decentralisation, there are risks that it may hinder the integrity of the national fiscal consolidation strategy, and weaken the quality and cost-efficiency of public services. To avoid these outcomes, *small municipalities should be further amalgamated, joint provision of services should be encouraged, and additional fiscal rules should be introduced to ensure better coherence between central and sub-central fiscal policies.* In addition, as corruption risks in regional and municipal governments are particularly high, it is critical that *the auditing apparatus at the sub-central level be reinforced.*

The Slovak authorities have begun to introduce public management reforms which have the potential to accelerate resource reallocation and improve performance across the entire public sector. Performance-based personnel management and market mechanisms in the provision of services, which have just started to be introduced, could contribute to better outcomes in important service areas such as education, active labour market policies and health and social services. However, their introduction faces a number of professional and technical shortcomings and may imply employment adjustments. Given the very compressed wage structure in many parts of the public sector, the introduction of skill- and performance-based pay is particularly important but it is constrained by the budgetary burden of overstaffing. *Efforts to promote public management reforms should continue, and decentralisation should be used as a vehicle in their further implementation. Benefits from the introduction of these innovations should be widely publicised to help build stronger public and political support for their application.* ■

### **For further information**

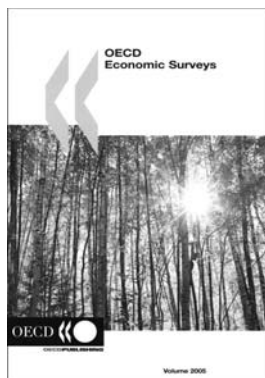
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- **Economic Outlook No. 77**, June 2005. More information about this publication can be found on the OECD's Web site at [www.oecd.org/eco/Economic\\_Outlook](http://www.oecd.org/eco/Economic_Outlook).

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Public Affairs and Communications Directorate.

They are published under the responsibility of the Secretary-General.

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