Structural reforms adopted in Slovakia – best practices

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The document offers a brief overview of the best practices of structural reforms adopted in Slovakia during its transition from a centrally planned economy to a market economy. It focuses on reforms adopted in 1998-2006 including privatization of banks and state monopolies, tax reform, labor market reform, pension reform, education reform, etc. as well as on measures aimed at increasing transparency and fight against corruption. It also includes basic facts on recent changes and current challenges. The document should offer an inspiration for reforms in other countries in transition, particularly in Ukraine. Based on specific requirements, INEKO can further elaborate on description of specific measures.

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The project is led by INEKO with following partners:

- The Polish Institute of International Affairs (Poland)
- Centre for Economic and Regional Studies of the Hungarian Academy of Sciences (Hungary)
- Centre for Economic and Market Analysis (Czech Republic)
- International Centre for Policy Studies (Ukraine)

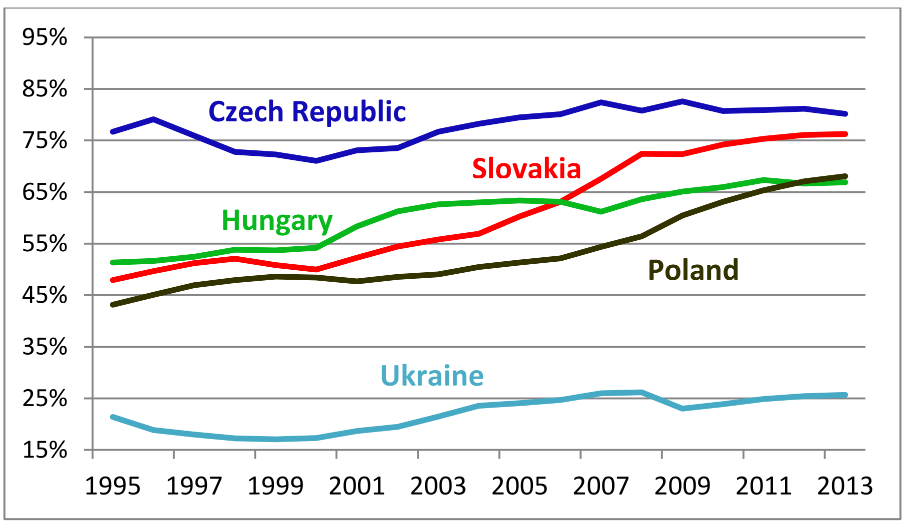
The Institute for economic and social reforms (INEKO) is a Bratislava-based non-governmental non-profit organization established in support of economic and social reforms which aim to remove barriers to the long-term positive development of the Slovak economy and society. See also http://www.ineko.sk/.

Introduction

Slovakia appears to be the most successful Visegrad country if we look at the GDP per capita development over the past two decades. According to Eurostat, it jumped from 48% of the EU average in 1995 to 76% in 2013, i.e. by 28 percentage points. Thus it substantially reduced the gap behind the Czech Republic (its GDP per capita increased from 77% of EU28 average in 1995 to 80% in 2013, i.e. by 3 percentage points), and was ahead of Hungary (up from 51% in 1995 to 67% in 2013, i.e. by 16 percentage points) and Poland (up from 43% in 1995 to 68% in 2013, i.e. by 25 percentage points). In Ukraine the GDP per capita in terms of the average of the EU28 increased from 21% in 1995 to 26% in 2013, i.e. by 5 percentage points.

The numbers show clearly that the results differ depending on the country. The case of the Czech Republic indicates that the sole integration into the EU, NATO, OECD and other international organizations is not a sufficient precondition for rapid GDP growth. It seems that the country benefits more from the integration potential if it implements structural reforms improving its business environment, attracting foreign investors with advanced know-how and culture and increasing transparency. The intensive privatization process together with the structural reforms in taxes, labor market, pensions, and other sectors as well as the measures aimed at increasing transparency and fight against corruption seem to be among the most important causes of rapid GDP growth in Slovakia.

GDP per capita in Visegrad 4 countries and Ukraine (in purchasing power parity, as % of EU28 average)



Source: INEKO based on data from Eurostat (for V4 and EU28) and the World Bank (for Ukraine)

Best Slovak practices

1. Political economy: Key success factor – influential group supporting reforms

   There are many barriers to adopt necessary reforms. Many of them are unpopular, in conflict with vested interests or technically difficult to design and implement. To overcome these barriers it is crucial to create an influential group of people supporting democracy and reforms willing to advocate their benefits and able to implement them. In Slovakia, key players involved a strong NGO sector with think-tanks playing the crucial role, free media, experts and particularly bank analysts who were independent from the government and frequently commented in media on ongoing changes as well as pro-reform well educated politicians and policy makers implementing reforms.

2. Transparent privatization in 1999-2006 (international tenders, direct selling to strategic investors)

   After 1994 the government used mostly non-transparent methods of privatization preferring local investors linked to politicians. This included privatization of the steel industry (later re-sold to U.S. Steel), and the oil refinery (later re-sold to Hungarian refinery MOL). After 1999 the government started to privatize shares directly to strategic investors chosen in transparent international tenders with price as the single winning criteria. The key assumption was that the investors from democratic and developed countries would bring the advanced knowledge and the culture that would increase the speed of transformation of the whole industries and foster their competitiveness. At the same time the transparent competition for the best price would ensure the highest possible revenues for the state budget. Key privatization projects:

   - Banking and insurance sector (full privatization). Investors:
     - Banking: Erste, Raiffeizen, Intesa, UniCredit, etc.
     - Insurance: Allianz, Generali, etc.
   - Telecommunications (full or majority). Investors:
     - Fixed line operator: Deutsche Telekom (51% majority)
     - GSM: Orange, O2 (100%)
   - Energy (majority or 49% with managerial control, i.e. majority in board of directors). Investors:
     - Electricity distributors (49%): E.ON, EDF, RWE
     - Gas industry (49%): Gaz de France & Ruhrgas (in 2014 replaced by Czech energy holding EPH)
     - Power producer (66%): Enel
     - Oil pipeline (49%): Yukos (in 2006 bought back by government)

   The privatization of state monopolies required establishing new independent regulators and deregulation of prices with negative short-term impact on population particularly in energy sector.

3. Tax reform in 2003-04 bringing simplicity and lowering direct taxes

   The reform was based on following assumptions: The investors welcome simple system and lower taxation on corporate profits. Lower direct taxes have positive impact on work incentives and reduce tax evasion. Lowering direct taxes requires higher indirect taxes, which is unpopular. Therefore, referring to political economy, compensation for low income people is one of key preconditions for successful reform.

   The reform was followed by a huge foreign direct investment inflow. Compared to previous investment which was mainly driven through the privatization this time it was mainly green-field investment. New investors focused on the automobile and electronic industry (2005: Peugeot-Citroen, Kia; expanding production at Volkswagen; Sony, Samsung), later also on the IT sector (IBM, Dell). The launch of the production in newly built factories contributed to a strong GDP growth mainly in 2006-08. Since 2012, Slovakia has been the biggest automobile producer per capita in the world[1].

   Key measures[2]:

   - Unifying direct income taxes to 19% for individuals and businesses. The old system was strongly progressive with 5 personal income tax rates ranging from 10% for the lowest income to 38% for the highest income. The reform also decreased the corporate income tax rate from 25% to 19% and cancelled the dividend tax rate of 15%. The combined statutory corporate income tax rate and dividend tax rate dropped from 36.3% in 2003 to 19% in 2004. Thus, Slovakia had one of the lowest composite taxation of capital income faced by a private investor in the EU and OECD countries. In 2013 the government reintroduced the upper 25% rate of personal income tax and increased the corporate income tax to 23% followed by its decrease to 22% in 2014.
   - Increasing the indirect consumption taxes. In the old system there were two VAT rates: standard rate of 20% and reduced rate of 14%. The tax reform unified both and introduced a single VAT rate of 19%; later, lower 10% rate for books and drugs was introduced. The tax reform included an increase in the excise tax rates on mineral oils, tobacco, and tobacco products, spirits and beer.
   - Radical simplification of the tax code. The old system included 90 exceptions, 19 sources of un-taxed income, 66 tax-exempt items, and 37 items with specific tax rates. The reform abolished most of them, making the tax system much simpler and transparent, and eliminated speculation aimed at paying lower tax rates. The reform also cancelled three minor taxes – gift tax, inheritance tax and real estate transfer tax.
   - Increasing the basic personal allowance deductible from the tax base from €968 to €2,021 per taxpayer in 2004 (€3,803 in 2014). As a consequence, everybody with wage below approximately 40% of the average wage in the economy (€317 in 2014) did not pay any

[1] Source: http://www.eubusiness.com/news-eu/slovakia-economy.sva
[2] See also Goliaš (2005).

income tax at all. Others paid a uniform tax of 19% on the difference between their income and the tax-free income. In 2007 the government introduced gradual reduction of the tax allowance for people with higher income down to zero (known as a "tax for millionaires").

4. Labor market reform (2003) introducing more flexible Labor Code[3]:

    - Trade-off between Protection & Flexibility: Before the reform, the Labor Code ordered concurrence of notice period (3 months) and severance pay (2 months) bringing the cost of firing to 5 months (3 plus 2). The reformed Code ordered to option between taking a notice period and taking compensation after termination of contract (severance pay). It was not possible to take both the notice period and the compensation. The Code ordered 2-month notice period and 2-month compensation for employees who have been working with their employer for less than 5 years; and 3-month notice period and 3-month compensation for employees who have been working with their employer for over 5 years. These were the minimum limits valid if not agreed otherwise in a collective agreement. Thus, the cost of a termination of contract was brought down from 5 month-wages to 2-month wages in case of employment lasting under 5 years and 3-month wages in case of employment over 5 years. Here is a summary of changes to the (Non-)Concurrence of notice period and severance pay:
        - 2002: 3 months plus 2 months
        - 2003: 3 or 3 (2 or 2 for contracts lasting shorter than 5 years)
        - 2007: 2 plus 2 or 3 plus 3
        - 2011: 1 or 1 (for contracts lasting less than 1 year); 2 or 2 (for contracts lasting over 1 year and under 5 years); 3 or 3 (for contracts lasting 5 years and over)
        - 2013: Re-introduction of concurrence and gradual increase of protection: 1 plus 0 (for contracts lasting shorter than 1 year); 3 plus 4 (for contracts lasting 20 years and over)

Firing costs in effect from 2013 (in monthly wages)

	Notice period	Severance pay
Contracts lasting under than 1 year	1	0
Contracts lasting over 1 year and under 2 years	2	0
Contracts lasting over 2 years and under 5 years	2	1
Contracts lasting over 5 years and under 10 years	3	2
Contracts lasting over 10 years and under 20 years	3	3
Contracts lasting 20 years and over	3	4

Source: Labor Code of the SR

    - Increasing overtime limit from 150 hours to 400 hours yearly (40-hour working week, plus 8 hours overtime) for one employer and with worker consent. Exceptions were possible for agricultural seasonal work.

[3] See also Goliaš (2007) and Zachar (2010).

- Practically indefinite extension of the fixed-term contracts; currently limited to 2 years (with exception of seasonal works) with possibility to sign a new temporary contract not sooner than 6 months after elapsing of this 2-year period.
- Weaker Labor Unions: They lost veto power in organizational changes including firing the employees and introducing flexible work time.
- Besides these measures there are three other frequently used forms of flexible employment in Slovakia:
    - Working „agreements“: Concluded only for a limited time (1) per week for regular employment or (2) per year for irregular employment. These agreements offer flexible entry/exit and until 2012 they were also freed from social security contributions.
    - Agency work: Specialized agencies employ workers who are then hired by real producers. The agencies organize workers among many producers to minimize costs related to closing the job (such as severance payment, etc.).
    - Self/employment
- 2009: Flexible working time account (in Slovak so called Flexikonto). Its introduction was motivated by problems in sales and in maintaining production and employment which have employers due to the global economic crisis. When a company announces a production break, flexible working time arrangements valid until the end of 2012 helped to retain skilled workforce and avoid mass layoffs. The “Flexikonto“ allowed employees to stay at home on full basic pay, with the un-worked hours being recorded in individual employee accounts. Later, after the economic difficulties are over, the employee is obliged to work those missing hours in the form of overtime and free of charge. At that time, legal overtime limits were not applied. Some companies, mainly in the automotive (Volkswagen Slovakia) and electric industries used the above mentioned flexible working time account several times in 2009, when their production was stopped for some weeks. In 2013 this arrangement became permanent if agreed between employer and employees (for example in collective agreement). However the limit of 8 hours of overtime weekly was applied and the period for balancing the working time was limited to 30 months.

5. Pension reform (2004-05) linking benefits to contributions and introducing fully funded second pillar[4]

- Trade-off between Merits & Solidarity
    - Pension formula guaranteeing 50% replacement rate: Pension = Average personal wage point (APWP) * Number of years of insurance * Constant indexed by wage growth
    - Gradual linking of contributions to benefits: APWP represents the ratio of individual earnings to average earnings in the economy. It is determined as an average of ratios respective to each year since 1984 till the retirement year (thus, the contribution base was expanded from 5 best of 10 latest years before retirement to cover most of

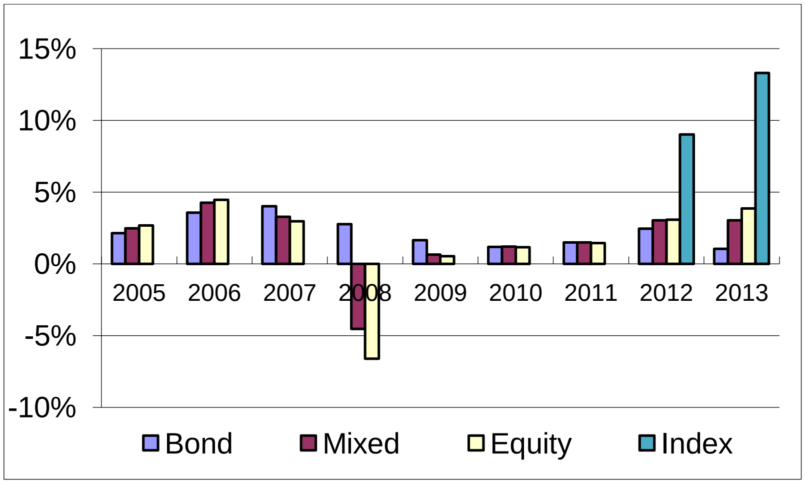
[4] See also Vagač (2013).

the working life of individual). APWP equal to 1 would mean that the worker has earned the average wage in the economy. The maximum value of APWP is 3. The initial aim of the 2004 pension reform was to gradually decrease, with the help of a correction coefficient, the solidarity component in the pay-as-you-go scheme so to have fully earnings-related pensions as from 2015. In 2011, the APWP adjustments had been freezed, and since 1 January 2013 values of APWP below 1 are added 17% of the difference between APWP and 1 (the percentage shall increase to a final 22% in 2018) and values between 1.25 and 3 are reduced to 80% of APWP (and shall gradually decrease to 60% by 2018). The aim of the revision is to increase solidarity in the calculation of new retirement pensions.

- Long/term financial stability:
  - Prolonging retirement age:
    - 2004: Gradually up to 62 years for both genders. The transition period was three years for men and 14 years for most women depending on number of their children.
    - 2017: Retirement age will be linked to life-expectancy. In line with expected longevity gains, the retirement age could increase by approximately 50 days per year.
  - Indexing pensions:
    - 2004: Automatic (average of wage growth and inflation)
    - 2012-16: Transition period: Increase by a fixed sum and/or inflation
    - 2017: Indexed purely by inflation for pensioners basket of goods
- Introducing second fully-funded pension pillar
  - 2005: 9% contribution rate (of gross wage). Diverting revenues from the pay-as-you-go pillar to private funds increases the public finance deficit. This transformation cost was covered by privatization revenues (2005-2009), later directly from the state budget.
  - 2012: In order to stabilize public finance deficit, the contribution rate was decreased to 4%. It is expected to grow up gradually to 6% by 2024. Savers may contribute with additional 2% and deduct the sum from their income tax base.
  - Investors (pension administration companies): Allianz, Aegon, AXA, ING, Intesa & Generali, etc.
  - Funds: Pension management companies (currently six) are obliged to administer two types of funds, a guaranteed bond fund and an unguaranteed equity fund. They can also run other types of guaranteed or unguaranteed funds (e.g. mixed and index funds). Until 31 December 2012, pension management companies administered four types of statutory funds (bond, mixed, equity, and index funds), while before 1 April 2012 there had been three funds (conservative, balanced, growth). Only bond and cash investments may now be included in bond funds. There is a 10-year running interval for balancing pension unit value in bond funds and savers have to be compensated for possible decreases. There is an upper limit of 80% on shares and also on bond and cash investments in unguaranteed equity funds. After reaching the

age of 47 years, savers may not be included in an equity fund, and after age 55 in no unguaranteed fund.

Gross returns of funds in the fully funded second pension pillar (weighted averages)



Source: INEKO

6. Education reform (2003) introducing per-pupil financing of schools

   - Introduction of "normative" financing based on number of pupils (i.e. normative = fixed amount of money per pupil) with equal financing of primary and secondary public and private schools. The goals were to increase transparency in financing schools and to increase pressure on their rationalization and efficiency – the quality should be guaranteed by free choice of school (students and their parents should choose the best). The normative system replaced the old system based on historical mostly cost-based and bargaining financing. The normative income covers around 94% of schools' current expenditure. It consists of wage and operation normative which may vary by a school type (e.g. grammar schools have different normative than vocational schools). The normative amount is given by a political decision about the state budget.
   - Tertiary schools are financed from public sources mainly based on number of students and research quality. The subsidies do not have a specified purpose („block grants"). The only exception is that personal costs cannot exceed 80% of the subsidy used for financing current expenditure. The attempt to introduce fees in tertiary education, as well as to open market to foreign investors failed. The state does not finance private universities with the exception of the social scholarships for students.
   - Current activities: Measuring quality (collecting and publishing school results, rankings) to overcome information asymmetry. INEKO (see http://skoly.ineko.sk/) uses following indicators for primary and secondary schools: Results of national standardized exit tests, financial rewards for exceptional results, unemployment rate of graduates (only for secondary), financial sources per student. Less relevant indicators: Student-teacher ratio, qualification of teachers, IT equipment, results of state inspections, etc. Most needed

improvements include measuring “value-added” (difference in results at the entry and exit from the school), measuring success of graduates when entering higher education (tracking students‘ path among schools), and collecting data about graduates‘ salaries and unemployment rate.
  - Future challenge: Efficiency-based financing (alternative to cost-based)

7. Increasing transparency and fight against corruption[5]

  - 1998-2002: Privatization of banks, telecom, and energy industry in transparent international tenders helped to increase financial health and competitiveness of the companies. Before privatization, these companies were often source of corruption and irresponsible management. For example before privatization the government had to clean banks’ balance sheets from failed credits provided by the state banks in the amount of more than 10% of GDP.
  - 2000: Free Access to Information Act allowed everybody to demand almost all information from public institutions, organizations, from municipalities, individuals and legal entities financed by public budgets. The provision of information cannot be refused on the basis of “trade secret”.
  - Open legislation: The portal http://jaspi.justice.gov.sk offers complete information from collection of laws and official gazettes. It includes actual as well as older versions of particular legislation. The “track-changes” is used to mark most recent changes. The portal http://www.rokovania.sk includes complete information on the consultation of legislative proposals with full texting of comments and reactions. Thus also the process of creating the legislation is fully transparent.
  - 2003: Online business registry (user-friendly, searchable)
  - 2004: Specialized Court and Prosecutor’s Office (focus on big corruption cases)
  - 2007: Online Land Registry
  - 2011: Publishing all property contracts and invoices of public institutions on internet. The contracts are not valid unless they are published. This measure means a shift from on-demand (i.e. based on information demanded by citizens) to automatic transparency. It allowed for creation of searchable portals (such as http://tender.sme.sk) displaying and comparing relevant information such as who were the biggest suppliers to the state, at what prices, etc.
  - 2011: Wider use of mandatory electronic auctions and other competition methods in public procurement. According to the Transparency International Slovakia this measure led to rise of bids in public tenders and to 6-15% savings.
  - 2012: Publishing court rulings on internet, random selection of judges
  - Current challenges: Open data initiative, measuring quality and efficiency of public services

8. Other reforms

[5] See also Goliaš (2013) and Zachar (2010).

- Health care[6] (2003, perceived as less successful)
  - Health insurers transformed to joint stock companies and some of them privatized (currently there are three insurers, the biggest one is state-owned), regulation of their profits based on waiting queues for selected diagnoses
  - Transferring 59 regional hospitals to regional governments and cities, their transformation to non-profit organizations or joint stock companies
  - Deregulation of prices insurers pay hospitals, selective contracting with minimum net of providers given by the government
  - Failure in introduction of legal marginal fees (per doctor visit, per nights spent in hospital)
  - Failure in narrowing the scope of services covered from public money
  - Drug prices referencing (based on three counties with cheapest drugs in the EU)
  - Currently: Implicit privatization of the biggest hospital – new hospital is planned to be built in a public-private-partnership project, replacing parts of the biggest state-owned hospital in the country
  - Future challenges: Improving information/data, measuring quality, rankings

- Social benefits reform (2004)
  - Social benefits conditional upon activity: Part of benefit in material need payable only upon participation in activation works (20 hours per week) or requalification
  - More frequent visits of unemployed at the labor offices
  - Single (i.e. not means-tested) child benefit payable if child attends a school
  - Tax bonuses for children (principle of negative tax): Introducing the bonus deductible from the income tax, conditional on at least one parent being employed. If the tax is lower than the tax bonus, the family receives the difference.
  - Current challenges: Focus on "work should pay-off" principle – designing tax-benefit scheme in a way that would support incentives to start working and gradually withdraw from taking social benefits (introducing in-work benefits, decreasing social security contributions for people with low income, etc.).

- Decentralization of power to municipalities and local governments
  - Shift of competences: Schools (pre-primary, primary, secondary), regional hospitals, social facilities, roads of lower classes, etc.
  - Shift of money: Fixed share on income taxes revenues transferred to municipalities and regional governments. The municipalities and regional governments directly collect property taxes and some other minor local taxes.

- Macroeconomic & Public finance stability

[6] See also Vagač (2013).

- National Bank of Slovakia independent from the government (low inflation, stable exchange rate)
- 2003: Audit at the Ministry of Finance implemented by Logica CMG; reducing number of employees by one third, increasing wages of remaining staff
- Strengthening independent analytical capacities at the Ministry of Finance: Establishing Boards on Macroeconomic and Tax prognosis consisting of representatives of the Ministry of Finance, National Bank of Slovakia, Slovak Academy of Sciences and private banks – majority vote is necessary for approving the prognosis used for state budget calculations. Establishing the Institute for Financial Policy at the Ministry of Finance (analytical unit).
- 2009: Euro adoption
- 2012: Constitutional Act on Budget Responsibility introducing the debt brakes and establishing the Council for Budget Responsibility
- Increasing transparency (disclosing hidden debts, ESA95, ESA2010, Fiscal Compact – computing and publishing structural deficit and consolidation effort, INEKO portal on financial health of municipalities: http://www.obce.ineko.sk/)
- Since 2013: Improved efficiency in tax collection (disclosing fraud cases, introducing electronic central evidence of invoices)

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