

Country in transition: increasing competitiveness of the Slovak Republic. Sharing reforms & EU accession experience.

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Foreword

Once upon a time, the Ireland was called “the Economic Tiger“. Slovakia is currently being called by some politicians and economists as “the Tatra Tiger³“. But we all know, what happened in the Ireland during the World economic crisis (2009-2011), so we would be careful with any simile, even Slovakia’s economic progress in the last decade, esp. on the eve and after the EU accession is remarkable.

The Slovak Republic has been one of the most dynamic economies in the EU. Over the past decade, it has continued to converge towards the living standards of advanced countries at a fast pace. Its gross domestic product (GDP) per capita growth was the highest in the OECD between 2001 and 2011 and still is one of the highest. The income gap relative to the upper half of OECD countries narrowed from over 60% in the early 2000s to close to 40% in 2013⁴.

With the financial crisis, the Slovak Republic experienced one of the steepest declines in real GDP, but also one of the fastest recoveries. The evolution of the Slovak economy mirrored developments in world trade as the country is highly dependent on exports. GDP contracted by 5.3 % in 2009, but rapidly picked up again, with GDP growth reaching 4.8% in 2010. Growth slowed down between 2010 and 2014, but still being one of the highest among the EU countries and is projected to accelerate in 2015-2016 thanks to stronger export markets, investment and domestic demand.

At the beginning of the transition process, Slovakia was labelled as “a late comer”. But it seemed to become a kind of a “star performer” in the first decade of the 21st century. Although the pace of reforms has slowed down in the last years, the Slovak economy provides a good example of a relatively successful transition that is esp. related to EU accession process. However, the Slovak Republic today is still faced with a number of economic challenges which will need to be addressed in order to ensure durable and sustainable economic growth which benefits everyone in the long run. Some economists call it as a “3rd stage of reforms”, shifting from “manufacturing” to “knowledge” economy, shifting from “wage competitiveness” to “technology competitiveness”. This stage will be very demanding on the quality of the labour force and on ability to cope with smart specialisation of the economy. This must be done in the situation of the ageing population, high regional disparities in the Slovakia, a persistently high unemployment rate, skills deficit and, as the economy heavily relies on the inflow of foreign direct investment and an increasing vulnerability to the intensifying global competition for mobile capital.

Transition towards market economy is an unprecedented process with a relatively clearly defined starting point, but a more difficult definable “end”. Transition of the economy ends when⁵:

- a functioning market mechanism has been build,
- the economy is able to generate a strong and sustainable growth and,
- distortions have been eliminated, which enables an equal interaction of the economy with more advanced market economies without any stronger protection.

³ The High Tatras (Vysoké Tatry) are the highest mountains in the Slovakia. According to the ‘World Bank Doing Business’ survey, Slovakia was ranked the top reformer in the business environment in 2005 and according to BusinessWeek, ‘Slovakia earned the title of Tatra Tiger’ (BusinessWeek, 2006).

⁴ OECD, 2013.

⁵ Morvay, 2005.

At the present time, not all of the markets work sufficiently well in the Slovak economy, e.g. the capital market. Prior to the global financial and economic crisis, economic growth had been relatively strong, however, the next years will fully examine in what extent it is also sustainable. As regards the third condition, one of the weaknesses of the Slovak economy consists in the fact that it is competitive only in a relatively few types of goods. Low labour costs are still the main competitive advantage of the Slovak economy, while technology gap remains large.

Box 1: Transition stages in Slovakia

1990 – 1992: Shock therapy - transition strategy within Czechoslovakia

- ♦ Deep transition recession during 1991-1992,
- ♦ Swift privatization along three fronts (restitution, small-scale privatization, voucher privatization),
- ♦ Price liberalization,
- ♦ Peaceful break-up of Czechoslovakia and foundation of two independent states

1993 – 1998: Independence and the stalled transition

- ♦ On January 1, 1993 foundation of the independent Slovak Republic,
- ♦ Foundation of Slovak currency and the National Bank of Slovakia
- ♦ Expansionary fiscal policy
- ♦ Fixed exchange rate
- ♦ Liberalisation of the foreign trade and minor liberalisation of regulated prices
- ♦ Crowding – out effect, high interest rates due to suboptimal policy mix- macroeconomic instability

1999 – 2002: Macroeconomic stabilisation & implementation of first reforms before the EU accession

- ♦ Managed floating exchange rate (October 1998),
- ♦ Restored short-term macroeconomic stability
- ♦ Gradual liberalisation of prices in network industries
- ♦ Restructuring and privatisation of the banking sector incl. bank system reform
- ♦ Restrictive fiscal policy
- ♦ Accession to the OECD (2000)

2003 – 2006: Structural reforms and EU accession

- ♦ Significant reforms implemented (tax reform, pension reform, social insurance, labour market)
- ♦ Public finance reform, pension system reform, labour market reforms
- ♦ High inflow of FDI, expansion of the automotive industry, privatisation.
- ♦ Accession to the EU, NATO, ERM II and EMU
- ♦ Accelerating growth of GDP

2007 – 2011: Eurozone accession & World economic crisis

- ♦ Impact of the economic crisis, first recession since the 1993.
- ♦ Euro adoption in 2009
- ♦ Rising unemployment, structural problems
- ♦ Deterioration of budgetary balances. Fiscal expansion in 2009, after 2009 consolidation of general government deficit.
- ♦ Gradual deconstruction of flat tax system, changes in the pension systems, labour market policies (especially the labour code)

2012 – Onwards: Looking for new “balanced” growth models

- ♦ Looking for new growth & socially oriented model e.g. changes in the pension system, “social packages” of government
- ♦ Changes in the tax system
- ♦ Supporting home demand
- ♦ Increasing the role of state in economy & higher support of R&D
- ♦ Supporting the status of the „car industry economy“
- ♦ Huge public investment into public infrastructure esp. high-ways, using also EU funds

Source: Authors.

Slovakia – today

Slovakia, population 5.4 mil., is according to OECD high income country, today. According to UNDP, it belongs to 49 countries of the World with very high human development (ranked 37). Thanks to the reforms and the growth in the last decade, Slovakia is reaching 76.2 % GDP per capita (in PPS) to EU28 average, while in the year of the EU accession (2004) it was just 53.3 % and before the reforms done in 1995 it was 47.0 %. However, distribution of growth is uneven at the regional level, while Bratislava (capital) region became 6th richest region in the EU in 2013 with 184 % GDP per capita in PPS (EU28 = 100 %), while the Eastern Slovakia is among the poorest with 52 %⁶.

Slovakia's economic freedom score is 67.2 according to the Heritage Foundation⁷, which ranks the freedom from corruption, business freedom, labour freedom, monetary freedom and the management of government spending. Slovakia is ranked 22nd out of 43 countries in the Europe region, and its overall score is higher than the World average. Slovakia's basic economic environment still needs improvement. The rule of law is weak, allowing corruption to flourish, and there is a lack of transparency in the government and state-owned sector. Despite some progress, business regulations remain inefficient, and labour market rigidity has prolonged the downside of business cycles. The financial crisis and the weak regional environment have undermined public finances.

Table 1: Slovakia – key indicators

Indicator	Value
Population total / females by 31.12.2014 (Eurostat)	5 421 349 / 2 779 021
Life expectancy at birth, years, males / females (EU 28 in bracket), 2013 (Eurostat)	72.9 (77.8) / 80.1 (83.3)
Urban population, in % (Eurostat)	53.6
GNI per capita in US\$ in 2014 (IMF)	17 390
GDP per capita in EUR in 2014, market prices, PPS, Slovakia / EU28, (Eurostat)	20 800 / 27 300
Labour productivity per hour worked (ESA95), Slovakia / EU 28, in EUR, 2013 (Eurostat)	13.2 / 32.1
Energy intensity of the economy, in % of GDP, (kg of oil equivalent per 1 000 EUR), Slovakia / EU 28, 2013 (Eurostat)	337.2 / 141.6
Employment rate 2014 / nat. target EU2020 in % (Eurostat)	65.9 / 72.0
Gross domestic expenditure on R&D, 2013 / nat. target EU2020, % of GDP (Eurostat)	0.83 / 1.2
Share of renewable energy in gross final energy consumption, in %, 2013 / nat. target EU2020 (Eurostat)	9.8 / 14.0
Tertiary educational attainment of age group 30-34, in % of total population, 2014 / nat. target EU2020 (Eurostat)	26.9 / 40.0
People at risk of poverty or social exclusion, in % of total population, 2014 (Eurostat)	18.4
Human Development Index 2014 (UNDP, out of 187 countries)	Rank 37, score 0.83
Index of Economic Freedom 2015 (Heritage Foundation, out of 178 countries)	Rank 50, score 67.2
Global Competitiveness Index 2014-2015 (out of 144 countries)	Rank 75, score 4.2
Doing Business 2015 (World Bank, out of 189 countries)	Rank 37, score 71.8
Corruption Perception Index 2014 (Transparency International, out of 174 countries)	Rank 54, score 50.0

Source: Authors, data from several resources, mostly from Eurostat.

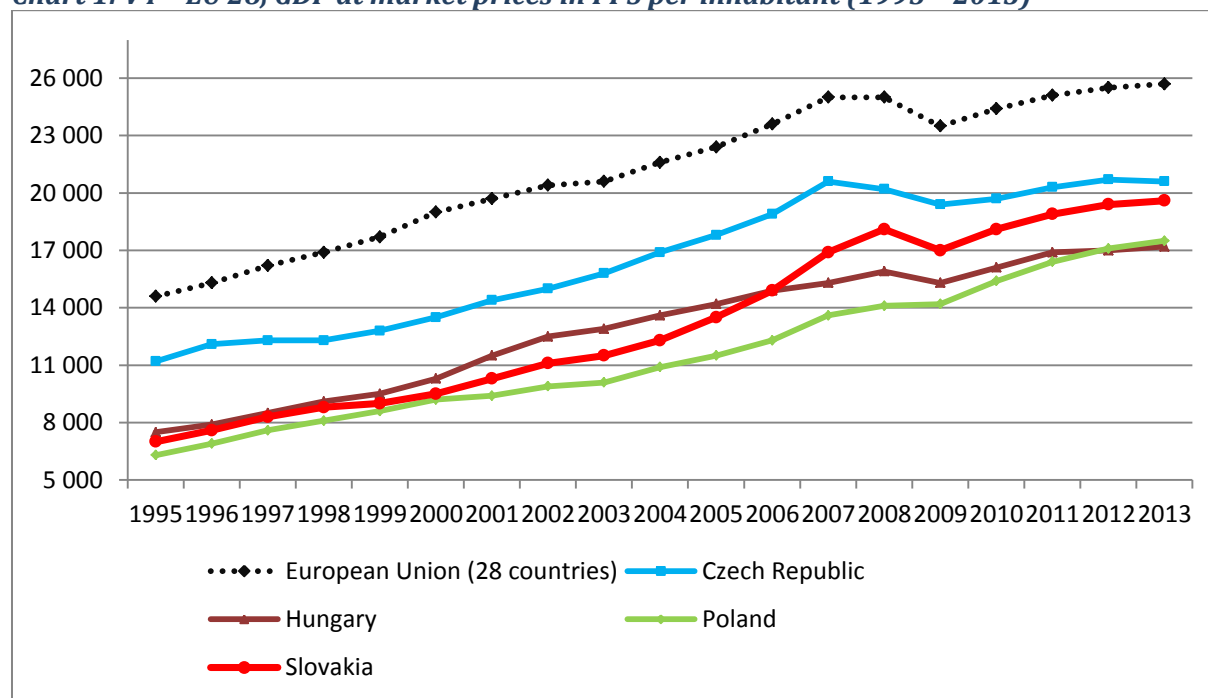
⁶ Eurostat (2015) – see more at: <http://ec.europa.eu/eurostat/documents/2995521/6839731/1-21052015-AP-EN.pdf/c3f5f43b-397c-40fd-a0a4-7e68e3bea8cd>

⁷ Heritage Foundation (2015) – see more at <http://www.heritage.org/index/pdf/2015/countries/slovakia.pdf>

The most problematic factors for doing business in Slovakia are identified in the Global Competitiveness Index⁸, and are as follows: Inefficient government bureaucracy (17.0 %), Corruption (16.1 %), Restrictive labour regulations (14.5 %), Tax rates 10.3 (%), Tax regulations (10.1 %), Inadequate supply of infrastructure (9.3 %), Policy instability (7.7 %), Inadequately educated workforce (6.3 %), Access to financing (2.8 %), Poor work ethic in national labour force (2.0 %), Insufficient capacity to innovate (1.8 %) and other 1% (e.g. Inflation 0.2 %).

Slovakia has been definitely one of the fastest growing economies among the EU countries. Strong and persistent rise in labour productivity led to economic growth without increasing employment in Slovakia. Labour productivity per hour worked in relation to the EU28 average has been higher only in Slovenia, when comparing former socialistic countries (now members of the EU). At the same time, performance of the Slovak economy in 2013 for the first time in history has overtaken one of the economies of the "old" EU Member States (EU-15). Slovakia achieved higher GDP per capita in PPS than Greece, which, due to badly hit by the debt crisis experienced declining economic performance in recent years.

Chart 1: V4 – EU 28, GDP at market prices in PPS per inhabitant (1995 – 2013)



Source: Authors, data from Eurostat (2015).

Since 1993 till 2013, the level of real GDP per capita in Slovakia has increased around 125 %, average nominal wage about 363 % and consumers price level about 202 %. It is interesting that the employment rate (15-64 years) was in 2013 at the same level (59.9 %) as it was at the beginning of its measurement in 1994. However, this cannot be interpreted as stability of employment rate: there was a phase of increase and decrease. The current employment has different features than before: it swept through structural changes and considerable part of it moved from not perspective activities to competitive activities. Nevertheless, this does not change the merit of the problem. Even after 20 years of transition, it is still reaching the same insufficient level as years before and is distant from the EU average (72.0 % in 2014)⁹.

⁸ World Economic Forum (2015).

⁹ Eurostat (2015).

Transformation process reduced the share of agriculture and industry, esp. the manufacturing industry in the economy, on the one hand and increased share of services on the other. This principle applies to the entire transition period, before the EU accession, and after. An exception is non-market services, whose shares decreased gradually, but are coming back to the same shares in the recent years. Interesting in this respect is the construction sector that was heavily influenced by the very favourable development after the EU accession (also thanks to the EU cohesion policy and infrastructure building and modernisation) and could maintain a decent position in the structure of the economy even after the several recession years during the World economic crisis.

Table 2: Share on selected sectors in economy (added value & employment)

Sector	1995	2000	2004	2008	2013	Change 1995 - 2013
Share on added value, in %						
Agriculture	5.7	4.5	4.1	4.1	3.0	-2.8
Industry	31.1	28.8	30.0	28.8	26.7	-4.4
Construction	5.3	7.2	6.4	10.0	7.6	2.3
Services	58.0	59.5	59.5	57.1	62.8	4.9
- of which non-market services*	14.1	14.4	13.6	12.1	13.5	-0.6
Share on employment, in %						
Agriculture	9.6	6.2	4.7	3.6	3.2	-6.4
Industry	29.8	28.2	27.0	26.3	23.6	-6.2
Construction	6.5	6.0	6.8	8.1	7.6	1.1
Services	54.1	59.6	61.5	62.0	65.6	11.5
- of which non-market services*	22.5	22.4	21.9	20.0	20.4	-2.0

Note: * - such as public administration, army, education, health sector ...

Source: Authors, data from the Statistical Office of the Slovak Republic (2015).

When comparing the competitiveness of the Slovakia with some other EU economies, it is clear that is based on other factors than the knowledge economy. Slovakia is very export dependent and is becoming depended on some key sectors such as a car industry. Slovakia ranks first in the World with the production of 183 cars per 1,000 citizens, while the Czech Republic followed in 2014 second with 118 cars per 1,000 citizens. Slovakia's three carmakers (Kia Motors Slovakia, PSA Peugeot Citroën, Volkswagen Slovakia) made 973 370 cars in 2014. And the carmaker Jaguar Land Rover signed in August 2015 memorandum with Slovak Government to open their new plant in Slovakia¹⁰, starting the production in 2018. However, further transformation of the economy towards the knowledge one will be very difficult, cost-demanding and probably very long.

Narrowly specialized export manufacturing has been a major pillar of Slovakia's development model. The share of the three important export classes – cars, electronic consumer goods and machines – increased from 26.0% to 53.2% between 1995 and 2012. The export production is highly reliant on imported inputs and technology. Transnational companies producing in Slovakia have hardly been engaged in research and development activities and low wages remain the major attraction of FDI.

Narrowly specialized export manufacturing was strongly affected by the steep decline in export demand in 2008/2009 and, thus, proved highly vulnerable to the crisis. In 2009 the contraction of exports was stronger in Slovakia than in the other EU countries and subsequent recovery

¹⁰ See e.g. <http://fortune.com/2015/08/11/jaguar-land-rover-slovakia/>.

highly reliant on the performance of the German export industry; while manufacturing employment has recovered much more slowly than production.

In view of these structural limitations and vulnerabilities, the competitiveness of the Slovak industrial model, established on low wages and low taxes is not sustainable in the long run. In addition, the regional concentration of manufacturing in the Western Slovakia is key to the nation's uneven regional development patterns. Past industrial growth has not significantly contributed to reducing high unemployment levels in the Central and Eastern parts of the country.

Reforming the country in between 1989 – 1999

After the fall of the “Iron Curtain” in 1989, Slovakia used the opportunity for regaining its independent statehood since 1st January 1993. It faced a double challenge: 1. to introduce economic reforms leading to a market economy, 2. to build the basic economic institutions needed for managing an independent state economy (e.g. ministries, central bank, own currency, capital market institutions etc.).

Until accession to the EU, but especially in the first stage of transition (years 1990-1996), a number of fundamental economic reforms had to be implemented in (Czecho-)Slovakia.

These reforms were related to:

- liberalisation (of prices, trade and foreign exchange),
- macroeconomic stabilisation (to deal with the external and internal imbalances),
- restoration of private property and setting the conditions and the legal and institutional framework needed for an economy based on private enterprises and economic activities (including privatisation of state-owned property and enterprises),
- repayment or renegotiation of the accumulated foreign debt and, in general,
- capitalisation of the national economy (including the reform of the banking and financial sectors and the attraction of foreign capital and investments),
- the reform and development of public finances (to make an effective use of fiscal policy in support of the other economic reforms and in order to maintain and further develop an appropriate level of public services).

Czechoslovakia's political power in the early years of transition decided for very radical reforms (the so-called “shock therapy”), despite its big negative impact in the short-term (output fall, unemployment growth and recession). The starting point of the economic transition was represented by one-shot price liberalisation, which was followed by further rapid liberalisation steps including abandoning of wage regulation, introduction of internal convertibility of the currency (Czechoslovak Koruna) and opening of the domestic market to international competition, which gave an impulse to beginning of production restructuring. In addition to the liberalisation package, stabilisation measures were adopted in order to contain inflation and a negative development in the balance of payments. The key elements of stabilisation policy included restrictive monetary and fiscal policy.

Devaluation of the currency resulted in significantly undervalued exchange rate, however, in a long term a sustainable one. The undervalued exchange rate helped to maintain competitiveness of majority of production in the Western markets and partially replace exports to the COMECON¹¹ countries that almost collapsed. On the other side, the undervalued currency

¹¹ The Council for Mutual Economic Assistance established in 1949 by socialist countries.

decreased motivation of enterprises for product innovation. Re-institutionalisation of foreign trade was enabled when Visegrad countries signed the Central European Free Trade Agreement (CEFTA)¹².

In Slovakia as well as in the Czech Republic, it was inevitable to accomplish conversion of armament production, reduction or closing of inefficient mining and over-equipped metallurgical production, restructuring and modernisation of several traditional industries in engineering and consumer industries.

Economic policy in Czecho-Slovakia in between 1990-1992 preferred macroeconomic stabilisation to economic growth. Although macroeconomic stabilization programmes in the first stage of transition were temporary successful, they did not lead to a sustainable growth of the economy. In Slovakia a high price had to be paid for reducing inflation and for lower budget deficit. Due to disintegration of COMECON, price liberalisation and restrictive monetary policy, the Slovak GDP fell significantly. The cumulative loss of GDP reached more than 25 % of GDP in between 1989-1993 and it took Slovakia 10 years to get to the same GDP level as it was in 1989 (but in a different quality in 1999: 85% of GDP was already created by private institutions). Transition recession was deeper than expected and caused increase in unemployment and poverty as well as awareness of the existing regional disparities.

Gaining the independence, the first changes of the transition strategy started to be implemented at the end of 1993. Although becoming a part of the European integration process was one of the most important priorities of the government, the actual outcome was quite the opposite. The existing democratic deficit excluded Slovakia from joining the first wave of post-socialist states, which opened accession negotiation to the EU and NATO. The conclusion of the EU Luxemburg summit and the Madrid NATO summit in 1997 stated¹³, that although Slovakia is basically fulfilling the economic criteria for accession, the existing democratic deficit and insufficient application of democratic principles are major obstacles for opening accession negotiations. With the exclusion of Slovakia from the first wave of EU accession talks, Slovakia was in less favourable position to attract FDI and was perceived as less reliable partner than the rest of the transition countries – esp. all other Visegrad countries.

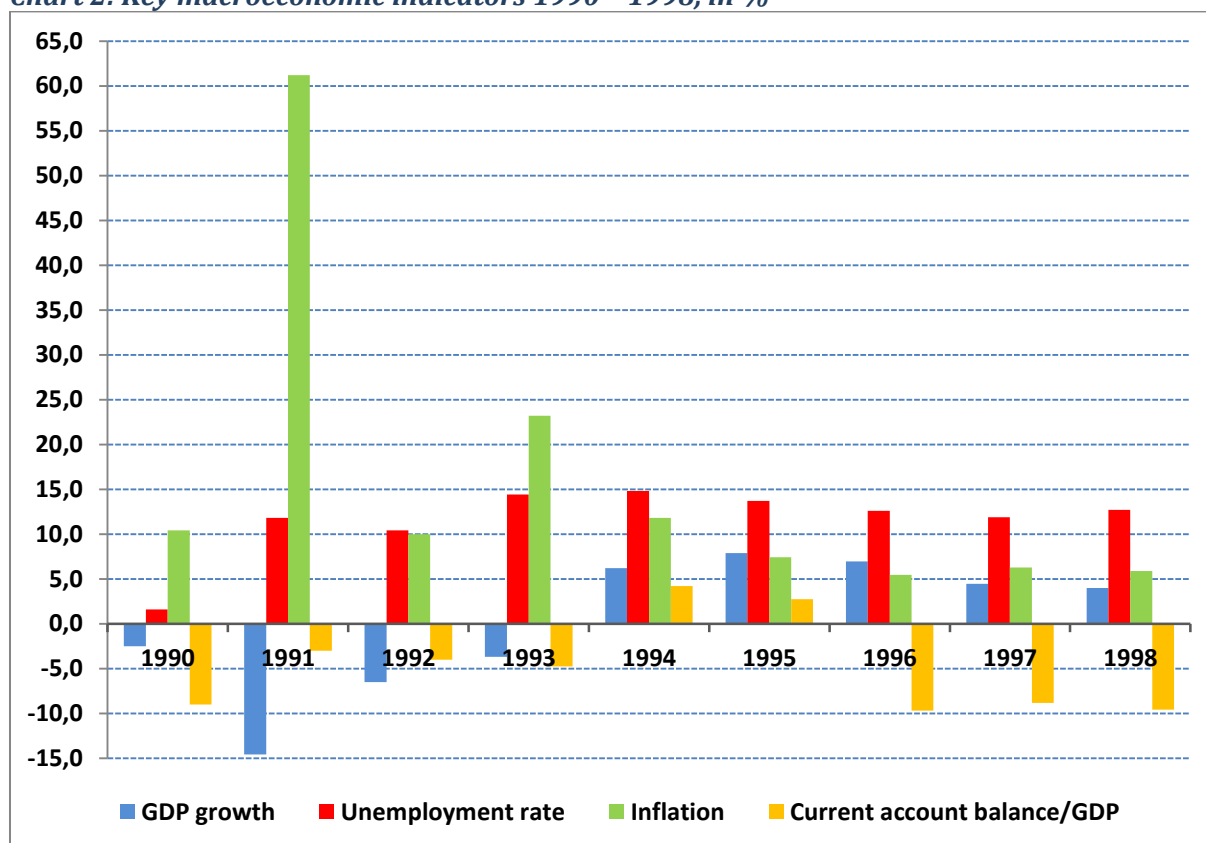
Paradoxically, in this period Slovakia experienced rather high GDP growth rates. The average economic growth in 1994 – 1998 reached 5.9 % (in 1995 the annual GDP growth reached even 7.9 %). However, the rapid economic growth was not sustainable due to the dominant role of the government consumption.

The expansive fiscal policy (e.g. financing of large infrastructure projects by short term loans with high interest rates) was accompanied by the restrictive monetary policy of the National Bank of Slovakia, which resulted in rapid increase of interest rates and significant crowding-out effect in the economy. In 1996 the annual real growth rate of government consumption went up by 17.4 %. Furthermore the volume of general government debt grew by 111.6 %, which represented an increase by 12.4 percentage points relative to GDP.

¹² Signed on 21st December 1992 by Poland, Hungary, and Czecho-Slovakia. Slovenia joined in 1996, Romania in 1997, Bulgaria in 1999, Croatia in 2003. CEFTA helped to prepare for the EU accession and internal market.

¹³ The US Secretary of State Madeleine Albright under President Clinton called Slovakia „the black hole in the heart of Europe“ in 1997 due to undemocratic and authoritarian behaviour of the government led by prime minister Vladimír Mečiar.

Chart 2: Key macroeconomic indicators 1990 – 1998, in %



Source: Authors, data based on the IMF - The World Economic Outlook database (2015).

It can be concluded that the 1st stage of reforms till the end of 1998 failed and Slovakia was excluded from the EU integration process. The unsustainable fiscal policy, stagnating restructuring of the economy, the lack of momentum to implement further structural reforms and growing external and internal imbalances resulted in significant macroeconomic imbalances in the next period. The privatisation process was highly influenced by political decisions, with the objective to create the so called “Slovak capital stratum”, composed of enterprises owned solely by the Slovak entrepreneurs. However, the majority of enterprises under control of these entrepreneurs were knowingly led into bankruptcy (so called “tunnelling”). The lack of relevant legal procedures and laws, the existing links between politicians and entrepreneurs made this behaviour possible, without any significant legal sanctions. As a result, the low inflow of FDI, international isolation of the Slovak Republic, expansive fiscal policy and restrictive monetary policy created significant macroeconomic imbalances.

Key problems of the 1st stage of the transition can be summed up to: focusing on short-term aims, not solving institutional problems and generally “no structural reforms performed”, very bad regulatory framework, corruption, privatisation that didn’t lead to good governance of companies, high share of public expenditures and destabilised fiscal policy, and conservation of socialistic industrial structure of economy.

Success story of the EU accession from 1999 till 2007

The crucial turning point, which led to implementation of standard macroeconomic policies in the next stage of Slovakia transition, was the result of the parliamentary elections in 1998. A

huge political coalition against the current prime minister and his party was organised and the new left-centre-right government had been appointed.

New government implemented several measures in 1999 – 2001 with focus on macroeconomic stability:

- introduction of hard budgetary constraints on so called “strategic” state owned enterprises,
- measures towards a more transparent accounting of revenue and expenditure in the public finances,
- implementation of necessary institutional reforms: bankruptcy laws, changes in the position of natural monopolies (mainly network industries), increase of transparency of company ownership etc.,
- partial elimination of price distortions (price liberalisation),
- changes in the regulation of financial markets,
- depreciation of the Slovak koruna against the US dollar,
- the National Bank of Slovakia abandoned the fixed exchange regime in favour of managed floating exchange regime,
- increase of the reduced VAT rate from 6 to 10 %,
- introduction of import fees at 7 %,
- gradual abolishment of state guarantees to enterprises,
- abolishment of Specific State Funds and their integration into the general government budget,
- realisation of bank system reform, incl. consolidation and privatisation of state owned financial institutions,
- wage freeze in public sector,
- and many other.

However, these measures were not accompanied by deeper structural reforms in some areas (social security reform, healthcare reform, justice sector reform, education system reform etc.) due to the opposing views in the government on the need of further structural reforms.

As a result of the economic policy and the restructuring of enterprises, the average unemployment rate reached 18.1 % in period 1999-2002. The highest unemployment rate in Slovak history of 19.2 % was recorded in 2001. The employment rate oscillated close to 48.5 %. However, the labour productivity per worker employed increased from 53.9 % in 1999 to 60.4 % of EU27 average in 2002. The implementation of macroeconomic policies helped to reduce the general government debt from 47.8 % of GDP to 43.4 % in 2002. In 2000 the share of general government debt reached even 50.3 % of GDP. This rapid increase was caused by the need to undertake the restructuring of financial sector, which was highly under-capitalised and suffered from significant volume of non-performing loans. The total cost for restructuring of banking sector reached approximately 5 % of GDP in 2000.

Box 2: Bank system reform (1999-2001)

Key measures

- ♦ Securing the independence of National bank of Slovakia
- ♦ Strict regulation of banks esp. in the area of loan supervision
- ♦ Paying off “bad” loans in amount of 4.5 bil. EUR
- ♦ Bankrupting “bad” banks and privatisation of the whole banking sector based on international tenders - foreign investors (esp. Austrian, German and Italian banks) entered into the recovered banks

Source: Authors.

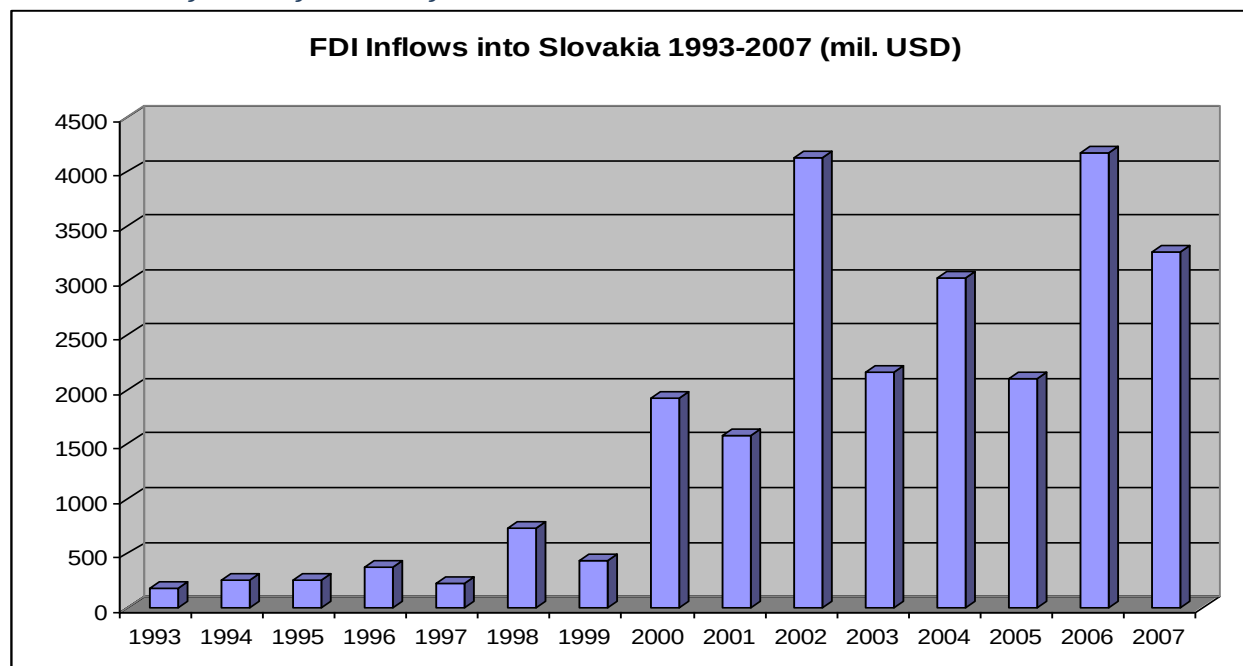
The large scale privatisation of state owned enterprises increased the inflow and stock of FDI, helped to recapitalise the economy and provided the necessary financial resources for the stabilisation of general government budget.

Thanks also to improvements in the political sphere, the EU members states during the Helsinki summit on 10th December 1999 decided to open accession negotiations with Slovakia. On 9th October 2002, the European Commission approved the accession of Slovakia to the EU in 2004.

Huge FDI inflows into Slovakia between 1999 and 2007 were also affected by these factors:

- Changed political climate – accession into NATO and EU
- Improving economic situation and business environment
- Interesting economic reforms – especially the “famous tax reform”
- Low labour costs – the lowest in V4 countries
- Generous investment stimuli provided by the government to strategic investors
- Improving performance of the SARIO – agency responsible for the FDI inflow and promotion of Slovakia abroad

Chart 3: FDI inflows before and after EU accession



Source: Authors, data from the National bank of Slovakia

After the 2002 parliamentary elections, a more coherent government has been formed with the dominant position of centre-right parties. This provided unique opportunity for continuation of previous economic policy and implementation of more thorough economic reforms. Significant efforts have been made in this period to catch-up with the Visegrad countries and conclude negotiations for EU accession.

The average annual GDP growth in period 2003-2006 reached 6.2 %, which contributed to reduction of unemployment rate from 17.4 % in 2003 to 13.3 % in 2006. The employment rate grew by 1.6 percentage points since the beginning of the period and reached 51.2 % in 2006. The rapid economic growth combined with relatively sound budgetary policies (the average general government deficit reached 2.8 %) resulted in decrease of public debt from 42.4 % to

30.5 % of GDP. Positive tendencies have been also recorded in labour productivity, which increased by 4.6 percentage points. Despite the implementation of large scale reforms in various sectors of the economy and public sector, some sectors have been omitted. The reform of education system as well as R&D and innovation support has not been implemented. The share of total R&D expenditure on GDP went down from 0.57 % in 2003 to 0.49 % in 2006.

Significant reforms in between 2002 – 2005 have been implemented in the field of public finance, especially in the tax system, which later became a “symbol” of economic reforms of Slovakia. Slovakia introduced a flat tax rate with 19 % on personal income as well as corporate income taxes. The uniform VAT tax rate at 19 % was introduced and most of the excise duties had been increased. The main idea was to shift from income taxation to consumption taxation.

Further measures included the implementation of fiscal decentralisation, creation of the State Treasury and the Debt and Liquidity Management Agency. These two institutions have improved the public finance management with following effects:

- Increase of the state budget revenue.
- Cost reduction of state debt management.
- Increased transparency and quality of information on the development of public finance management.
- More efficient financing of the state budget deficit during the fiscal year.
- Reduction of transaction costs among the individual public sector organisations etc.

Box 3: Fiscal reform (2002 - 2005)

Aim: to increase the effectiveness of the use of public financial resources

Transparency of expenditures

- ♦ Limitation of state guaranties to private and state owned companies
- ♦ Implementation of EU standards to public administration (ESA 95 + IPSAS, budgeting, reporting, accounting)

Strengthening of the strategic planning

- ♦ Midterm framework of public finances (multiyear budgeting at least for 3 years), programming in budgeting (aims>activities>budget)

Joint prognosis for public administration

- ♦ New analytical centre of the government - IPF
- ♦ Macroeconomic and tax prognosis system using independent experts and private sector

Centralisation of financial flows of public administration

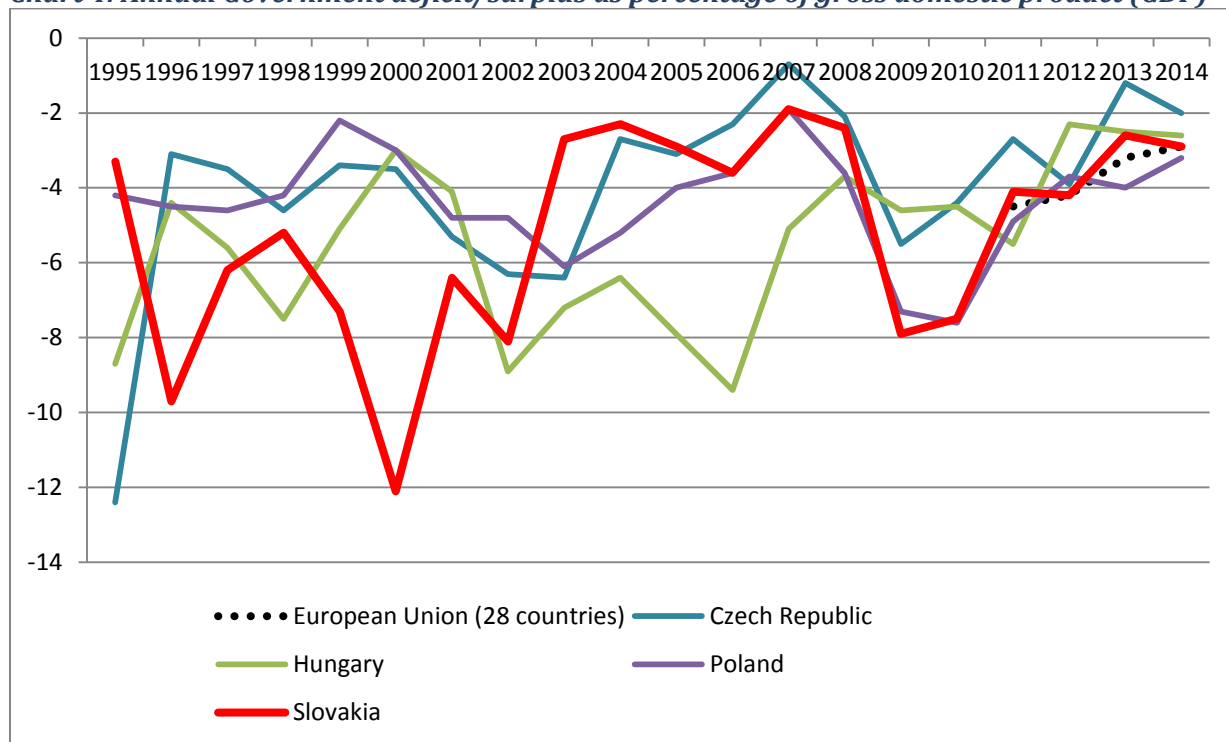
- ♦ System of state treasure-house - one account for whole public administration (except municipalities and higher self-governing units)
- ♦ Creation of the Agency for management of debt and liquidity (ARDAL)

Source: Authors

Implementation of common methodology ESA 95 was the key factor in increasing of public finance transparency. Government completely stopped offering state credit guarantees and eliminated almost all state funds contributed to transparency increase and implementation of tough budget restrictions. Program budgeting (budget planning for 3 years ahead) have strengthened strategic planning and effectiveness control of public resource usage.

In fact, between 2000 and 2008, public finances improved markedly with the budget deficit dropping from levels as high as 12.1 % of GDP in 2000 to 1.9 % in 2007. Reflecting positive developments in the budget balance, gross debt as a share of GDP also declined noticeably, reaching 28.2 % of GDP in 2008.

Chart 4: Annual Government deficit/surplus as percentage of gross domestic product (GDP)



Source: Authors, based on the data from Eurostat (2015).

Furthermore, a complex reform of the social system has been implemented, based on three principles: motivation of citizen, activity of citizen and benefit for citizen. Changes realized in social, tax and pension system as well as in public administration were mutually interconnected. The framework of the pension reform conducted in the 2003-2005 period included three pillars (two compulsory and one voluntary) of future pension income. The first compulsory pillar, performed by the Social Insurance Company, is based on the pay-as-you-go system and has a strong solidarity aspect. The second pillar represents an old-age pension saving performed by the pension funds management companies. It is based on compulsory savings and is strongly income-oriented. The third pillar, based on voluntary savings, is supplementary pension insurance performed by the supplementary pension companies. The pension age was increased to 62 years for both men and women.

Box 4: Social system & pension system reforms

Social system reform

Aim: increasing targeting of social system and motivation to work

- ♦ Help to working families (children allowances: single whole territory allowance and tax incentive > motivation for parents to work)
- ♦ Supporting working mobility
- ♦ Targeted social benefits (decreasing the basic social benefits and introduction of work incentive benefits)
- ♦ Changes in unemployment allowance (e.g. tightening the conditions for applicants, reduction of time for support etc.)
- ♦ Changes in health support allowance (e.g. first 10 days of inoperability are paid by employer)

Pension system reform

Aim: sustainable public finances, introduction of 3-pillar system

- ♦ Changes in 1st pillar (continuous system)
 - increasing the working/retirement age till 62 years, valorisation of pensions based on combination of inflation and wage growth
 - increasing the meritoriousness (increasing maximum pension limits)
 - contributions at 18% of the assessment base payable solely to the PAYGO system
 - (early) old-age pension paid exclusively by the Social Insurance Agency
 - recommended option particularly for people who will not be able to accumulate sufficient pension savings to purchase life annuity at the time of retirement
- ♦ Introduction of new 2nd pillar (capitalisation/saving system) since January 1, 2005
 - change of ownership: individual pension accounts managed by private pension funds, the contribution ratio - 9% DB : 9% DC, possibility to choose from conservative, balanced and growth saving strategies, survivors' pensions (widow's, widower's and orphan's pensions)
 - minimum 15 years' period of saving
 - designed primarily for people who will be able to contribute to their pension accounts for at least 20-25 years
- ♦ 3rd pillar (supplementary pension saving)
 - special-purpose saving and the life insurance with tax incentive (400 EUR annually)

Source: Authors

The government also implemented in 2004 a unique public administration reform and fiscal decentralisation that created dual system of public administration in Slovakia since January 1st, 2005. Main aim was to have more effective functioning of the public administration and support subsidiarity. More than 300 competences were transferred from the government and ministries to municipalities and higher self-government units in the first stage. Later on, another 100 competencies were transferred. The key areas of decentralisation were: transport (e.g. roads of 2nd and 3rd class, local roads), social affairs, regional schools (kindergartens, basic and secondary schools), agriculture, health, construction, culture, regional development and many others.

Decentralisation was connected with fiscal decentralisation that included:

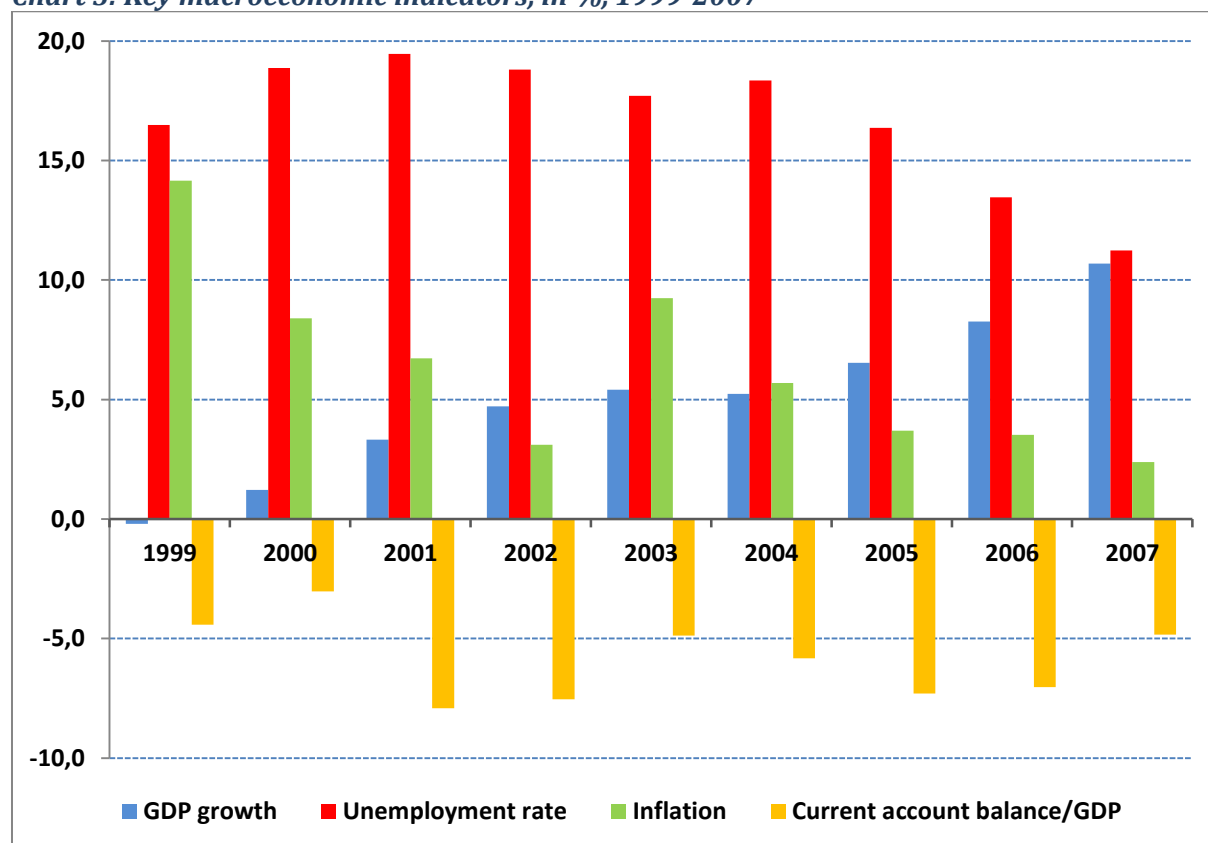
- Right to have and manage own taxes of municipalities and higher self-governing units.
- New distribution mechanism for several taxes e.g. income tax of private persons.
- New fiscal rules (balanced current budget, limitations for loans).

The key problem of the reform was that it was implemented at the end of period of ruling government and it was not finished. One of the problems was unfinished “municipalisation” – uniting small villages into bigger administrative units. So, until today there are plenty of small villages (not economically effective) in Slovakia, concretely 2 933 municipalities, of which only 138 are the towns. Furthermore, 1 145 municipalities have less than 500 inhabitants.

This transition period (1999 – 2007) clearly pushed Slovakia to liberal market economies. The reform and principles of the social system, the tax reform, privatisation of state owned enter-

prises and the generally negative attitude toward state interventions and state ownership were the most prominent features of the economic policy. Despite the liberal market orientation, the importance of attracting foreign direct investment and competition among the Visegrad countries in this area forced the government to provide substantial investment aid from public sources (see sub-chapter on the state aid).

Chart 5: Key macroeconomic indicators, in %, 1999-2007



Source: Authors, data based on the IMF - The World Economic Outlook database (2015).

EU accession process & reforms

As written above, unlike its Visegrad neighbours, the European Union excluded Slovakia from starting accession talks after the Luxembourg summit in December 1997. Slovakia became side-lined principally due to non-compliance with the Union's political criteria outlined by the EU summit held in Copenhagen in June 1993. Although the country managed to produce relatively good economic results, and in terms of living standards stood above some other candidate states, such as Estonia or even Poland, it was relegated to the second wave of applicants due to a lack of domestic political stability and major inconsistencies in democratic practice¹⁴.

Slovakia, in its attempt to reignite the process of preparation for accession to the European Union after the political changes at the end of 1998 cooperated closely with the European Commission. To foster Slovakia's efforts, the European Commission created a unique institutional tool: The European Commission–Slovakia High Level Working group, which met

¹⁴ The Commission's report prior to the decision at the EU summit in Luxembourg summarized Slovakia's political deficits together with its economic development. See European Commission, AGENDA 2000 – For a stronger and wider Europe, (Luxembourg: Office for Official Publications of the European Communities 1997).

five times between November 1998 and September 1999. The group consulted on several specific political, economic, and legal issues. One of the concrete outcomes of the group's work was Slovakia's pledge to close two blocks of nuclear reactors that formed a part of the nuclear power plant located in Jaslovske Bohunice. Slovakia managed to sign up to some of the biggest concessions vis-à-vis the EU (like the closure of the nuclear power plant) even before the official start of negotiations.

Slovakia's place at the negotiating table for EU membership created a strong impetus for reforming Slovakia's economy. The European Commission's 1999 Composite Paper described Slovakia, together with Lithuania, as "close to being functioning market economies." This report also stated that "if the reforms, which have been decided or are in the pipeline, are consistently implemented in the coming year, both countries should fulfill this sub-criterion in the course of next year"¹⁵.

In February 2000, Slovakia began official accession talks with the European Union and proved capable of completing the accession talks by December 2002. Together with nine other countries, Slovakia signed the accession treaty with the EU in April 2003. Bratislava was thus able to catch up in negotiations with the more advanced countries of the Luxembourg group and entered the EU together with Slovakia's Visegrad neighbours on May 1, 2004.

The accession negotiations shifted the principal focus on Slovakia's legislative compatibility with EC/EU law and created incentives for a speedy adoption of new laws and changes in the functioning of public institutions. Slovakia faced the task of implementing standards that had been in place in EU member states for decades. Yet the country was unable to influence these standards. ***Lesson learned was that Slovakia did not contribute to the process of EU integration. It "merely" took over the prescribed rules as the country's bureaucratic structures played the crucial role in technical adaptation and in monitoring Slovakia's gradual compliance to EU standards.***

Second lesson learned was that the relationship between the EU and Slovakia was largely characterized by a one-way transfer of EU rules and norms into the domestic Slovak legislative and political setting. The main task for Slovakia was to adapt to EU conditions. In some respects, negotiations are an exercise in efficiency rather than legitimacy. What is clear from the Slovak experience is that it was an exercise dominated by the executive. Not so much by the government as whole, but rather by concentrated bureaucratic elements within the executive. The more efficient the setup, the better your ability to perform in this very technical aspect of completing your commitment to the adoption of the EU legislative (acquis). This is also the reason why Slovakia was able to negotiate EU membership within three years.

The coordination of accession negotiations was in the hands of the Ministry of Foreign Affairs (MFA). The MFA through the Chief Negotiator and his team coordinated the preparation of domestic ministries for negotiations in each of the 31 substantive negotiating chapters. At the same time, the MFA and the departments headed by the Chief negotiator, together with the country's Mission to the European Communities, coordinated Slovakia's communication and negotiations with the European Commission and member states in Brussels. The Deputy Prime Minister's Office was responsible for domestic legal adaptation and implementation of EU compatible laws through the work of the Institute of Approximation, as well as for domestic coordination of pre-accession aid and public communication of EU issues. The Ministerial

¹⁵ European Commission, 1999.

Council for European Integration was a formal communication and advisory mechanism composed of the Deputy Prime Minister and the Ministers for Foreign Affairs, Economy, Finance, Agriculture, and Interior as well as the Chief Negotiator.

Slovakia's Parliament – the National Council of the Slovak Republic – adopted legislation that was indispensable to Slovakia's EU accession. However, the space for discussion over EU compatible rules was rather limited, as the parliament largely took over already existing directives or guidelines. There was no particular need for the parliament to maintain its own independent expert background regarding the issue of European integration. Parliament's communication with the Cabinet was determined instead by the needs related primarily to the harmonization of Slovakia's legal system with that of the EU. While the parliament also created its own internal structure of communication on EU issues and the European Parliament, the main task of this institutional setup was to ensure expedient adoption of new laws, rather than offer space for broad public discussion on details of European integration.

In fact, negotiations on accession were about the country's commitment to adapt to EU rules and norms as quickly as possible and in ways that were the least painful both for the EU, and for the domestic public and domestic structures. In terms of measures of success, Slovakia had to adopt commitments on some big issues such as the closure of the nuclear power plant in Jaslovské Bohunice, but also had to commit to the adoption of EU compatible laws, which today comprise more than 100,000 pages of legislation¹⁶. More importantly, Slovakia had to commit to when it would implement those laws. Today, Slovakia is in the EU, but actually is still implementing those commitments and is being closely watched by the European Commission and by other EU member states. This process creates pressure, although technically it is carried out by a small group of people. It creates pressure for the structures at large, and for society at large.

Third lesson learned was the importance of bilateral dialogue and negotiations with individual EU member states. There were arguably three kinds of issues that the member states brought to the negotiating table. One, they focused on agendas of high political salience within a specific country. The example for Slovakia is the closure of the nuclear power plant. Austria brought it to the table repeatedly. Another example is the competition policy. The subsidies provided to the Volkswagen plant located outside Bratislava became a very sensitive issue. Spain blocked the closure of the competition policy chapter with Slovakia for several weeks because they wanted assurances it would not affect negatively their Seat plant in Spain. As can be seen, there are specific issues of political salience particular to each member state. Candidate countries simply have to deal with them, and deal with member states using the Commission as your ally and while looking at EU rules and norms.

Second, there are horizontal issues. Concerning horizontal issues, there was not much that Slovakia was able to negotiate because these horizontal were sensitive for the majority of EU member states – specifically the 'four freedoms.' The freedom of movement of persons is probably the most sensitive. Goods and capital were settled quite fast. But Slovakia had to accept an agreement made between the older member states that up to seven years after entering the EU, the EU labour market was not entirely open to the new member states. And it was closely watched and monitored by the member states and the European Commission.

¹⁶ One technical aspect that helped Slovakia: Czech Republic being ahead of the negotiations already translated a lot of EU legislation into the Czech language that is very close to Slovak language and therefore it was easier and faster to work with the EU legislation. V4 countries also provided Slovakia with other negotiations „know-how“.

Third, each EU member state and European Parliament have to approve a new candidate's entry into the Union. Slovakia did fairly well in lobbying and finding friends in the EU. Other countries had more difficulty where certain questions were raised in the European Parliament. This is to be expected when at the stage of ratifying the accession treaty. It will end successfully only if you have friends not only in EU member states, but also in the European Parliament.

Generally, there was not a direct link between the EU accession and the economic reforms initiated before and even after EU accession. However, Slovak governments used the EU accession period very wisely to communicate reforms with the inhabitants of Slovakia. Reforms are painful. They are also costly. There are a lot of groups in society that are losing at the beginning of reforms and many are afraid of changes. The government often initiated reform with saying that "the EU accession requires such reform". We believe that the real problem with initiating the reforms is a domestic politics. Therefore, some reforms in Slovakia are not finished yet (e.g. health sector reform, justice sector reform etc.). It is also important to underline that each round of enlargement is different. Slovakia asked the Austrians, the Swedes, and the Finns what they did in their 1995 enlargement. Some of their experiences were useful, but not much, because they had a much higher level of integration with the European Community prior to joining, as compared to Slovakia.

Tax reform

According to Slovak economists¹⁷, the tax reform realised in 2004 was the key reform that increased Slovak economy competitiveness on the eve of the EU accession. A fundamental tax reform in 2004 introduced, among other changes, a single rate of 19% for personal income tax (PIT), corporate income tax (CIT) and value added tax (VAT). Before the tax reform, the PIT system had five income brackets, with marginal tax rates varying from 10% to 38%. The CIT rate was at 25% and the VAT had a standard rate of 20% and a reduced rate of 14%. The main objectives of this reform were to support growth, strengthen work incentives and send positive signals to investors. With this reform, the Slovak Republic became the first OECD country to have a flat PIT. The tax reform also broadened the PIT base by eliminating almost all tax reliefs, but increased the basic allowance to offset the tax rate increase for low-income workers. At the same time, the Slovak government reduced social assistance benefits and shifted the tax burden from direct to indirect taxation.

Box 5: Tax reform 2004 - summary

¹⁷ INEKO survey 2009, www.ineko.sk.

Aim: support of the production side of the economy, simplicity and effectivity of the tax system

Direct taxes:

- ♦ introduction of flat individual tax for private persons and companies (19%)
- ♦ elimination of dividend, inheritance, gift taxes, and real estate transfer tax
- ♦ elimination of virtually all exceptions, exemptions, deductions, special rates, and special regimes

Indirect taxes

- ♦ introduction of one single rate of 19% (before: 20% and 14%), 2007 – introduction of decreased VAT rate 10% for pharmaceuticals and health material, 2008 - books and newspapers
- ♦ harmonisation of excise taxes with EU

Results:

- ♦ shift from direct to indirect taxes
- ♦ radical simplification of the tax system
- ♦ introduction of low nominal rates (at that time lowest in the EU) - 19% flat individual income tax, 19% corporate tax, 19% unified VAT on all goods and services - without any exception

>>> transparent tax system that motivates investments

Tax rates changes in 2004

Changes in income tax rates		
(in %)	2003	2004
Personal income tax	2; 2,25; 2,5; 2,75; 10; 20; 28; 35; 38	19
Corporate income tax	15; 18; 25	19
Allowance tax	1; 5; 10; 15; 20; 25	19

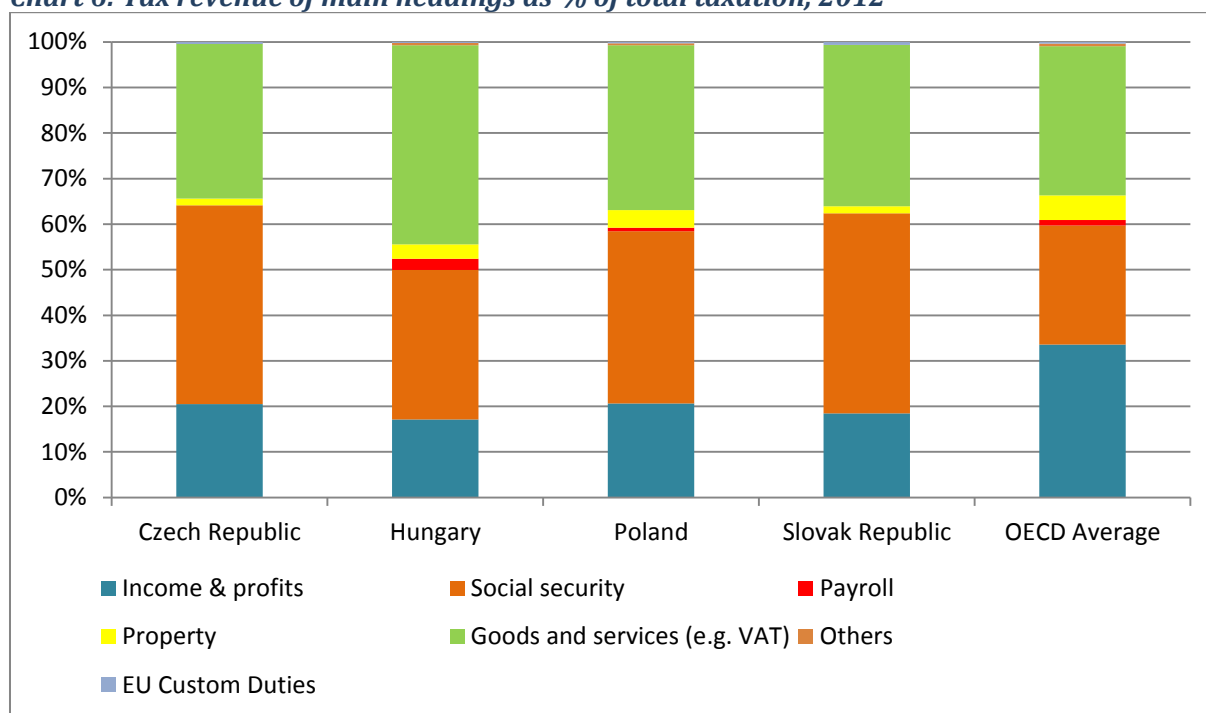
Source: Ministry of Finance of the Slovak Republic (2004).

The reform succeeded in making the tax system simpler, transparent and in enhancing economic efficiency. In addition, the introduction of the flat tax contributed to preserving the attractiveness of the Slovak Republic as a business location for domestic and foreign investors. However, the tax system continued to suffer from a number of weaknesses. Because social security contributions (SSCs) remained high, the overall tax burden on labour remained substantial. The tax wedge for low-income workers was particularly burdensome in light of the low skills of a large part of the labour force.

The Slovak Republic's tax-to-GDP ratio and tax mix diverge from OECD patterns. In particular, the Slovak Republic relies substantially more on SSCs than other OECD countries. In 2013, revenues from SSCs amounted to 13.3 % of GDP against an average of 9.0 % in the OECD. Revenues from PIT, on the other hand, were considerably below the OECD average, accounting for only 2.5 % of GDP. Taxes on goods and services as a share of GDP were somewhat below the OECD average, but constitute the Slovak Republic's second largest source of tax revenues. CIT revenues accounted for about 2.6 % of GDP, which is close to the OECD average of 2.9 %.

The Slovak Republic's tax structure is similar to tax mixes in V4 countries. Tax mixes in other V4 countries are also characterised by a high reliance on SSCs and VAT and more limited revenues from PIT as a share of total tax receipts in comparison to the OECD average. Some differences nevertheless exist between the Slovak Republic and other V4 countries. For instance, CIT revenues account for a greater share of total tax revenues in the Slovak Republic than in Poland or Hungary.

Chart 6: Tax revenue of main headings as % of total taxation, 2012

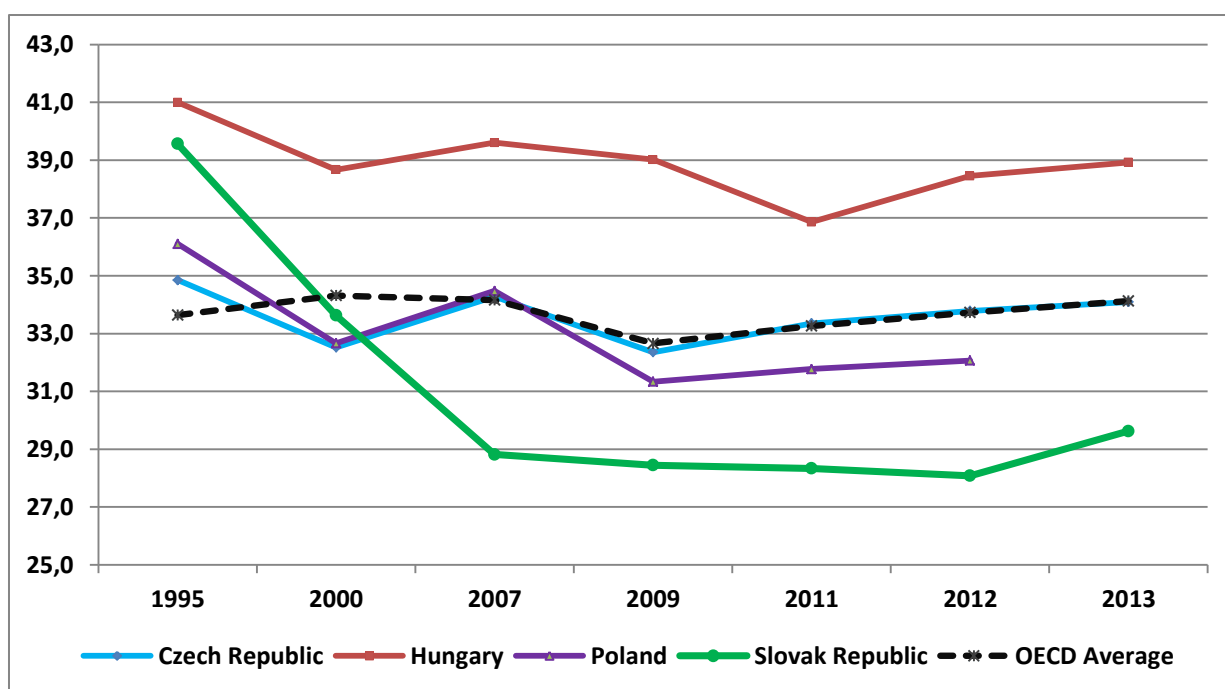


Source: OECD Revenue Statistics (2014).

The Slovak Republic does not collect any revenues from recurrent taxes on net wealth, inheritance and gift taxes or taxes on financial and capital transactions. Transaction taxes – unlike recurrent real property taxes are considered as detrimental to growth and should generally be avoided. A real estate transfer tax, for example, increases the costs of relocation and likely decreases labour mobility. However, taxes such as inheritance taxes do not negatively affect growth.

While this reform has contributed to the Slovak Republic's strong economic performance, less than ten years later, weaknesses in the tax system – especially the low level of tax revenues, the relatively distortive tax mix, the system's limited progressivity, the poor levels of tax compliance and the high tax wedge for low-income workers – became apparent. The country's overall tax burden remains well below the OECD average. In 2013, tax revenues in the Slovak Republic equalled 29.6 % of gross domestic product (GDP), 4.5 percentage points below the unweighted OECD average of 34.1% and several percentage points below the other Visegrad countries. One noteworthy aspect of the Slovak Republic's overall tax burden is the extent to which it has declined: its tax-to-GDP ratio fell from 39.6 % in 1995 to 29.6 % in 2013.

Chart 7: Total tax revenue as percentage of GDP



Source: OECD Revenue Statistics (2014).

High SSCs contribute to a high overall tax burden on labour. Average tax wedge for single taxpayers earning the average wage amounted to 41.1 % of total labour costs in 2013. OECD average is 35,9 %. Employer SSCs in particular accounted for about 24% of total labour costs in the Slovak Republic against an average of 14.3 % in the OECD.¹⁸ High compulsory payment wedge may be particularly problematic in light of the country's low level of skills. If labour costs are set too high relative to workers' productivity, the demand for labour will decrease. High employer SSCs are likely to price low-skilled workers out of the labour market and this effect will be even more pronounced in countries where skills levels are low.

Labour force productivity, particularly at low skills levels, should be increased through reforms and investments in education and training. These efforts would require structural changes and only have effects over the longer run. In addition to the government, the business sector plays an important role in raising the skills of the labour force..

At the same time, Slovakia's industrial production is extremely reliant on external demand, while credits are sustaining its domestic housing demand. Slovakia's real wage growth lags behind productivity growth, while its wage share is significantly lower than the wage shares of western European countries. The average wage in 2014 was EUR 858, however, average gross monthly earnings differs in Slovak regions, while in Bratislava region the average wage is EUR 1 205, and Prešov region just EUR 736.

Table 3: Slovakia's real wage growth and real productivity

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real Average Wages	1,8	1,4	6,4	3,4	6,2	0,9	3,2	3,7	-1,3	-0,9	0,4
Real Labour Productivity	4,3	5,5	4,8	6,1	8,4	2,2	-3,4	6,4	0,9	1,6	2,2

Source: National Bank of Slovakia (2014).

¹⁸ OECD Taxing Wages (2014).

To tackle these issues, the Slovak Republic introduced a series of tax reforms in 2013. These reforms included the introduction of a second PIT bracket and rate to increase the progressivity of the PIT system as well as an increase in the statutory CIT rate to raise additional tax revenues. More recently, the Slovak Republic introduced measures to counter VAT fraud, a minimum corporate income tax as well as a targeted social security contribution (SSC) exemption for the long-term unemployed.

Box 6: The main tax reforms introduced in 2013 and 2014

Corporate income tax

- The CIT rate was increased from 19% to 23% in January 2013.
- In 2014, the CIT rate was lowered to 22%.
- In 2014, a minimum corporate income tax was introduced. The minimum tax is either EUR 480, EUR 960 or EUR 2,880, depending on the company's turnover and whether it is registered for VAT.
- In 2014, tax loss carry forward rules were tightened. Under the new rule, tax losses may only be carried forward for a period of up to four years (as opposed to seven previously).

Personal income tax

- A second tax bracket and tax rate of 25% was introduced in January 2013. This rate is applicable to taxable income exceeding 176.8 times the valid subsistence minimum (for 2013 the threshold amounts to EUR 34,401.74 a year). Taxable income up to that threshold is taxed at a rate of 19%.
- As of 2013, the conditions to be entitled to the spouse allowance were made more restrictive. The spouse allowance is limited to a spouse who takes care (not necessarily personally) of a child up to 3 years old (or 6 years old if the child is disabled), or who receives a nursing allowance or who is unemployed or disabled.
- As of 2013, the possibility of deducting 40% of expenses without any bookkeeping for self-employed workers was limited to EUR 5,040 per year or EUR 420 per month.

Social security contributions

- As of January 2013, the assessment base to calculate SSCs for self-employed workers was adjusted by increasing its minimum level. It is also gradually being broadened by reducing the coefficient that previously lowered the base.
- In January 2013, SSCs were introduced for temporary workers to match those of regular employees.
- In January 2013, the SSC ceiling was raised for all employment types.
- In November 2013, an SSC exemption was introduced for the low-paid long-term unemployed for the first 12 months of employment.
- As of January 2014, the health contribution rate from dividend income increased from 10% to 14%

Source: Authors (2015).

The 2013 reforms have increased the tax burden on high-income earners. Indeed, the introduction of a second tax bracket (25 %)¹⁹, combined with the increase in the SSC ceiling²⁰ and the restrictions to the spouse allowance have resulted in higher compulsory payment wedges for high income individuals.

Many VAT counter-fraud measures were adopted as part of the 2012-2016 Action Plan to Combat Tax Fraud. Key measures adopted in the first stage aimed at cleaning up the VAT registry as well as fighting internal corruption and detecting major tax fraud cases. Efforts in the last stage of the Action Plan are focusing on improving tax collection, in particular through a better collection and centralisation of information and the introduction of an Electronic Registry of Insolvent Entities. For instance, joint teams of representatives from the tax office, the police and prosecution services, known as the 'tax cobra', were set up to detect major fraud cases. The last stage measures were approved in October 2014. These measures include the

¹⁹ As of 2013, the 19% flat PIT that was introduced in 2004 was replaced by a progressive tax. Annual income of up to four times the average wage (EUR 40,441 in 2014) continues to be taxed at the rate of 19% while income above this threshold is now taxed at the rate of 25%.

²⁰ In 2013, ceilings of 1.5 times the average wage for sickness and guarantee contributions, 3 times the average wage for health contribution and 4 times the average wage for remaining contributions were replaced with a single ceiling equal to 5 times the average wage.

introduction of a taxpayer risk-rating system and the obligation to indicate the risk-rating on tax documents, the establishment of a register of persons previously acting in fraudulent companies, the establishment of an insolvency register, and the introduction of more stringent conditions in the Bankruptcy and Arrangement with Creditors Act. Finally, the obligation to use cash registers was extended to doctors and other professions (experts, scientific and technical activities and accommodation services).

In September 2013, the government also launched a VAT receipt lottery through which citizens can win prizes if they register valid cash receipts. It may be assumed that the positive effect of the lottery on customers would be mostly in areas where the benefit of non-compliance is not distributed to customers (e.g. restaurants, small groceries). The lottery may have a more limited impact when the benefit of noncompliance is distributed between both sellers and consumers (e.g. services such as cars repairs, additional furnishing services). Nevertheless, the lottery has the potential to make all citizens aware that VAT evasion is illegal. From its launch up to the 26th draw in September 2014 (1 year), more than 450,000 consumers had registered nearly 87 million of receipts.

Competition policy and the State Aid system (incl. EU accession negotiation)

Competition policy – institutional and legislative background

The Antimonopoly Office of the Slovak Republic (Antimonopoly Office²¹) was established already in 1990. The task of the Antimonopoly Office is to promote and protect economic competition in the markets for products, performance, work and services against prevention, restriction or distortion as well as to create conditions for its further development in order to promote economic progress for the benefits of consumers. The Office intervenes in cases of cartels, abuse of a dominant position, vertical agreements, it controls mergers that meet the notification criteria and assesses actions of state and local administration authorities if they restrict competition.

Slovak competition law is regulated by the Act No. 136/2001 Coll. on Protection of Economic Competition as amended, which is supplemented by two regulations of the Antimonopoly Office, that outline the requirements for merger notifications and calculations of turnover. The Slovak Competition Act entered into force on 1 May 2001 and it replaced the Act No. 188/1994 Coll. on Protection of Economic Competition and provided a completely new legislative basis for the competition policy in line with the EU standards. For the sake of completeness, it is necessary to mention that the new era of the competition law has begun with the approval of the Act No. 63/1991 Coll. on Protection of Economic Competition from March 1991, through which the competition protection rules were implemented into the Slovak law system again as a reaction to the gradual economy transformation and return to the free market economy.

The Competition Act applies to all undertakings active in all sectors of the economy. Its purpose is “to protect competition in the market for products, performance, work and services from any restriction and to create conditions for its further development with a view to promoting economic development to the benefit of consumers and regulating the powers and the scope of activities of the Antimonopoly Office”.

²¹ <http://www.antimon.gov.sk>.

On 1 May 2004 substantial amendments to the Slovak Competition Act came into force due to the Slovak Republic's accession to the European Union, in line with EU antitrust and competition policy and rules (and especially in light of the new EU competition regulations). The amendments aimed to create a legal framework for the fulfilment of tasks resulting from the Council Regulation (EC) No. 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty establishing the European Community and further approximation of the Slovak Republic's competition law to the *acquis communautaire* in the area of competition law.

The other area of the competition policy is the state aid (see the special sub-chapter below). Slovak Republic has harmonised the rules on providing state aid with the European Community (EC) legislation after its accession to the European Union on 1 May 2004. In Slovakia, the Ministry of Finance in accordance with the Act. 231/1999 Coll. on State aid, as amended is coordinating aid in relation to state aid providers in the Slovak Republic and in relation to the European Union. Slovakia is obliged to cooperate with the Commission on the State aid approval procedure, keep a record on the State aid granted under the "de minimis rule" and send the Commission annual reports on all existing aid schemes.

Generally, state aid may be provided on an individual basis or within a scheme of state aid. State aid is subject to the approval of the European Commission pursuant to Articles 87 and 88 of the EC Treaty. However, the above mentioned EC regulations contain a number of exemptions from the approval of the Commission. The exemptions include e.g.: 1) De Minimis Aid, 2) Aid to Small and Medium Enterprises provided that it fulfils all the conditions of the respective EC Regulation, such as the maximum of participation of aid in the investment (that differs depending on the economic development of the region), types of investment (e.g. investment to tangible and intangible assets, consultancy and other services), etc., 3) Training Aid - the exemption shall not apply if the amount of aid granted to one enterprise for a single training project exceeds EUR 1 million, 4) Aid for Employment of disadvantaged and disabled workers or for covering additional costs of employing disabled workers.

Applications for the aid from the state budget funds whether under certain scheme or individual are filed with the competent Ministry or to other competent entity entrusted with providing state aid. There is no legal title to the provision of state aid and its granting remains upon sole discretion of the government authorities.

Competition policy – EU accession negotiations

Already in 1993, when Slovakia signed the European Union Association agreement (came into force in 1995), the article 64 was dealing with the competition policy. Association process required implementation of the „Copenhagen criteria“ (political criteria, economic criteria, acceptance of the *acquis communautaire*) and Slovakia was negotiating 31 chapters, of which no. 6 was on competition policy.

The accession negotiations on competition policy started in 2000 and finished in december 2002. The key issue was the need for the acceptance of the *acquis communautaire* – Commitment of the Slovak Republic to harmonize its competition policy with the law of the European Union (incl. art. 64 of the Association agreement, and White paper – preparation of the associated countries of central and Eastern Europe for integration into the internal market of the Union). The obligation of the Slovak Republic was to ensure the effective enforcement of

harmonized competition rules in practice and to ensure the consistent application of the competition rules in the area of the „internal market“.

Negotiation Chapter 6 was divided into these topics:

- Competition policy: Antitrust; and Public undertakings and monopoly rights
- State aid

Screening of the competition policy generally focused on approximation of legislation (basic provisions and secondary legislation), its enforcement and institution building.

The attention of the European Commission in the area of **Antitrust policy** focused on compliance with the basic competition provisions (art. 85 and 86 EC Treaty, current art. 101 and 102 TFEU), on agreements restricting competition, abuse of dominant position and merger control. Furthermore it focused on approximation of the secondary legislation (block exemptions, exemption regulations in place or planned and on the existence and functioning of the competition authority to implement the law (The Antimonopoly Office – independence and sufficient powers, sufficient and trained staff). Required information was also in the area of enforcement practice (e.g. number of cases per year, type of cases, competition culture, private enforcement, problematic cases etc.).

After the screening process and several negotiation meetings, Slovakia started to implement measures, mostly before the EU accession. Such examples are:

- Harmonization of basic provisions (new Act on Protection of Competition no. 136/2001 Coll.)
- Setting the legal rules concerning “de minimis” and “block exemptions”
- Abolition of the exemption for the agricultural sector from the general ban of agreements restricting competition
- Harmonization of legal rules concerning merger control with actual EU legislation
- Increasing the independence of the Antimonopoly Office by creation of „the Council of the Office“ – the collective body of the Antimonopoly Office involving the independent experts, who participate in the decision-making process.

In the area of **public undertakings and monopoly rights**, the focus of the European Commission was on prohibition for public authorities to infringe competition provisions in the case of public undertakings and undertakings to which special or exclusive rights are granted (art. 90 (1) EC Treaty – current art. 106 (1) TFEU) and exemptions (art. 90 (2) EC Treaty- current art. 106 (2) TFEU), on general liberalisation measures esp. in telecommunications and postal services, on gradual adjustment of national monopolies of a commercial character (art. 37 EC Treaty- current art. 37 TFEU), on competences of competition authority and separation between public regulator and public enterprise functions, as well as on the regulatory system to ensure conditions of fair competition between existing operators and new entrants (access to networks etc.). Slovakia also provided information on existing enforcement in practice (individual cases, competition culture, competition advocacy...).

Important part of negotiations in Chapter 6 was related to undertakings with special or exclusive rights esp. in selected sectors: railway transport, postal services, telecommunications, insurance, radio and television broadcasting and other. EC was also interested on the actual situation in particular sectors in regards of state monopolies of commercial character and e.g. on the system of authorizations and licences in the Slovak Republic (licences for export and import).

The outcome of the negotiations in the area of public undertakings and monopoly rights resulted in description of needs to be tackled, e.g.:

- Elimination of discrimination ensuing from the exclusive rights related to imports and exports of goods, their retail and wholesale distribution – creating of equal conditions for an establishment of undertakings and for a performance of entrepreneurial activities
- Abolition of the state monopoly for the foreign trade, export and import of goods
- Abolition of state monopolies for the production and sale of salt, tobacco and alcohol products
- Regulation of natural monopolies (telecommunications, postal services, insurance, water economy, transport, energy sector, radio and television broadcasting)
- Enhancing the transparency of financial relations between the Slovak Republic and public undertakings
- Railway transport – unbundling of activities relating to operation of the infrastructure and commercial services
- Postal services – limitation of the scope of the postal reservation for the Slovak Post
- Insurance – the abolition of exclusive rights of Slovak insurance company to provide the motor vehicles compulsory insurance

Most of the measures taken to tackle these issues were implemented before the EU accession.

In the area of the **state aid**, the EC focused on the general principles of the state aid control (legislative framework, overall compliance with the acquis – art. 92, 93 EC Treaty- current art. 107 and 108 TFEU), transparency of the state aid system (state aid inventory, submission of state aid reports etc.), enforcement (monitoring authority – legal basis, status, resources) and on the implementation of the state aid acquis (the extent of the compliance with the acquis, present situation regarding the implementation of the acquis, timetable for the adoption).

There were several challenges that Slovakia needed to focus on:

- creation of national state aid co-ordinating authority – The State Aid Office
- establishing a comprehensive state aid inventory
- need to bring into line with Europe Agreement aid measures which were granted contrary to EU criteria (notably in case of state aid into steel sector)
- the power of the State Aid Office to align all existing aid measures with the Europe Agreement
- preparation and enforcement of the legislative changes (the Act on State Aid) esp. in the area of prohibition of granting state aid where it may distort competition and has an adverse effect on the trade between the Slovak Republic and the European Union
- the extension of the scope of application of the Act on State Aid to all already existing aid measures (i.e. those programs which were already in the process of realisation in time when the new Act entered into force)

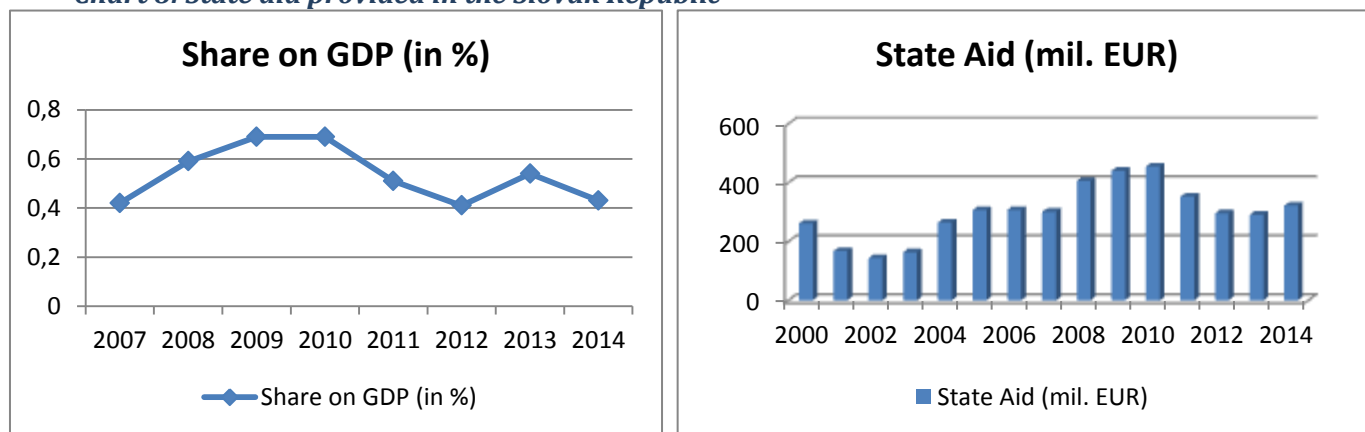
Two exemptions regarding the state aid were negotiated and approved by the EC for the Slovak Republic: 10-year corporate income tax exemption granted to one beneficiary in the automobile industry until 2008 and 10-year corporate income tax exemption granted to one beneficiary in the steel industry until 2011.

State Aid and investment incentives in the Slovakia

The total volume of state aid granted in Slovakia in 2014 was EUR 322,14 million, of which EUR 189.86 million EUR was provided from national sources and EUR 132.28 million were provided by the European Union funds.

In 2014, state aid was mainly provided in the form of grants, non-repayable financial contributions (88.09 %) and tax credits (11.91 %), particularly for the development of regions (34.06 %), for energy production, transmission and distribution (21.78 %) and for the promotion of culture and preservation of cultural heritage (19.95 %).²²

Chart 8: State aid provided in the Slovak Republic



Source: Authors, based on the statistics from the Ministry of Finance of the Slovak Republic (2015).

Investment incentives²³ (or state aid) are one of the tools which are used to motivate investors to place their projects also in the less developed regions, i.e. the regions with higher unemployment, lower infrastructure quality, etc. The connection with a certain region is one of the fundamental characteristics of the incentives and their provision shall serve to support not only foreign, but also Slovak investments. Investment incentives are provided on the basis of the Act No. 561/2007 Coll. of 29 October 2007 on investment aid and amendments.

Four categories of projects that can be supported by the investment incentives in Slovakia:

- industrial production
- technological centres
- shared service centres
- tourism

Each category has specifically defined conditions which shall be met in order to apply for the investment incentives. The incentives are provided in the form of:

- a subsidy for the acquisition of material assets and immaterial assets (cash grant),
- an income tax relief,
- a contribution for created new jobs,
- transfer of immovable property or exchange of immovable property at a price lower than a general asset value

For the purposes of investment aid, the following long-term assets shall be considered as eligible costs:

²² For more information see the web site dedicated to State Aid in Slovakia: <http://www.statnapomoc.sk/>

²³ See more at <http://www.sario.sk/en>.

- costs of land acquisition
- costs of buildings acquisition and construction
- costs of technology equipment and machinery acquisition
- intangible assets – licences, patents, etc.
- wage costs of new employees for the period of 2 years

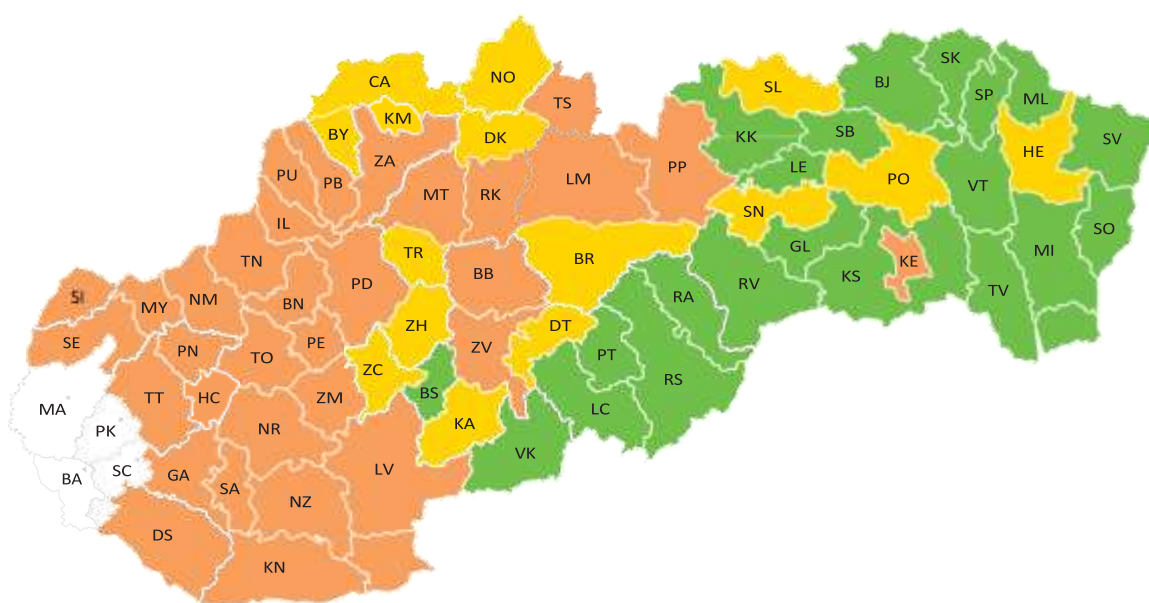
All production and technology equipment which is to be included in the eligible costs must be new (never depreciated), acquired under market conditions and manufactured not more than two years prior to its acquisition.

Box 7: Investment incentives in the Slovakia – case of industry

Minimum amount of investment for industry is subject to the unemployment rate in the selected district. Industrial investment projects must also lead to the creation of at least 40 new jobs (all districts). In case of expansions of existing establishments, the investment has to lead to an increase in the production volume or turnover by at least 15%.

Maximum Intensities of Investment Aid

	Zone A	Zone B	Zone C
Maximum intensity	35%	35%	25%
Cash grant	15%	10%	—
Income tax relief	35%	35%	25%
Contributions for new jobs (in EUR)	6 000	4 000	—
Transfer of property	35%	35%	25%



Source: SARIO (2015).

Facing the impacts of the World economic crisis (2008 – onwards)

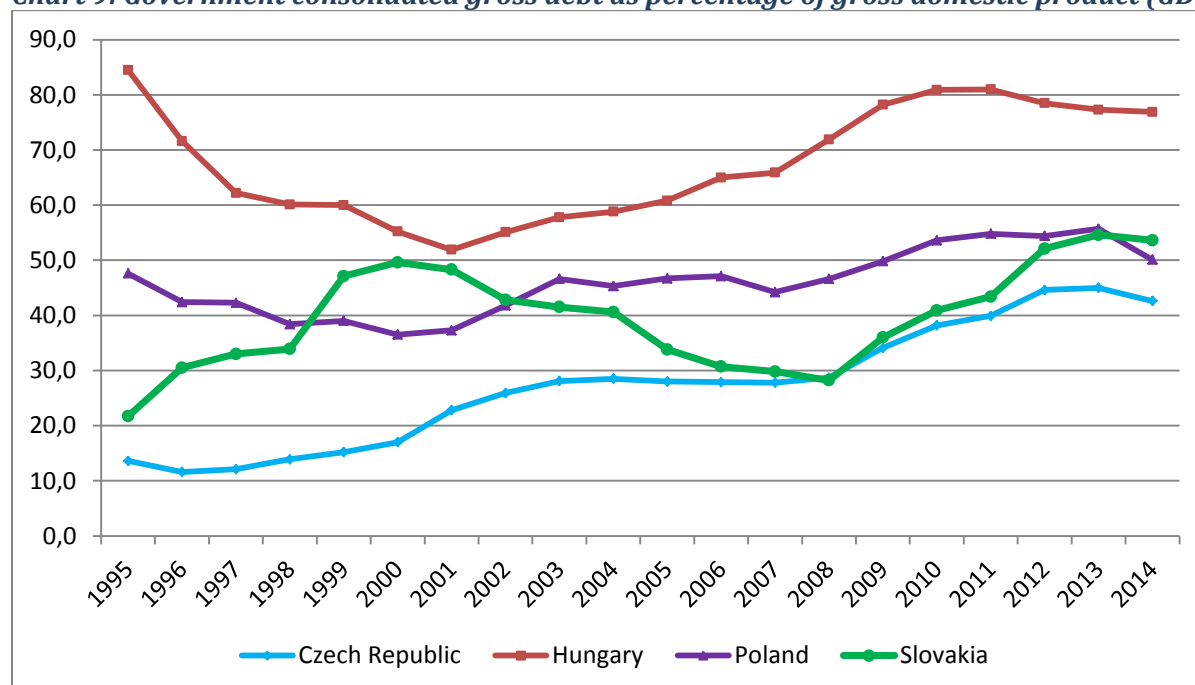
This period has been significantly affected by the economic crisis. The main factors, which contributed to the first recession experienced since the start of the transition, were rapid decline in external demand and gross fixed capital formation. The impact of the crisis resulted in:

- Annual decrease of real GDP by 4.9 % in 2009.

- Annual growth of unemployment rate by 2.5 percentage points to 12.1 % and even to 14.4 % in 2010.
- Deterioration of general government balance. The general government deficit went up to 8 % of GDP in 2009 and 7.7 % in 2010. Consolidation efforts supported by the recovery of economic growth reduced the general government balance deficit to 4.9 % in 2011.
- High growth of general government gross debt. In the pre-crisis period, the gross general government debt was steadily declining to 27.9 % of GDP, the lowest level since the beginning of the transition. Since 2009 to 2011 the general government debt went up by 15.4 percentage points to 43.3 % of GDP.

The gross general Slovak government debt is still well below the EU average, which was in EU28 at 80.9 % (2011) and 86.8 % (2014) level. Eurozone average level is even worse: 85.8 % (2011) and 91.9 % (2014).

Chart 9: Government consolidated gross debt as percentage of gross domestic product (GDP)



Source: Eurostat (2015).

Being in the EU doesn't mean that it is the end of reforms. The pension reform is still one of the most discussed reforms in Slovakia. The most problematic issue is the high deficit in the Social Insurance Company, which is responsible for the pay-as-you-go system. For this reason, the participation rate in the second pillar has been decreased from 9 % to 4 % of gross wages. Government also several times open the possibility for people to leave the 2nd pillar and register only for the 1st pension pillar, with the aim to raise money for the 1st state managed pillar.

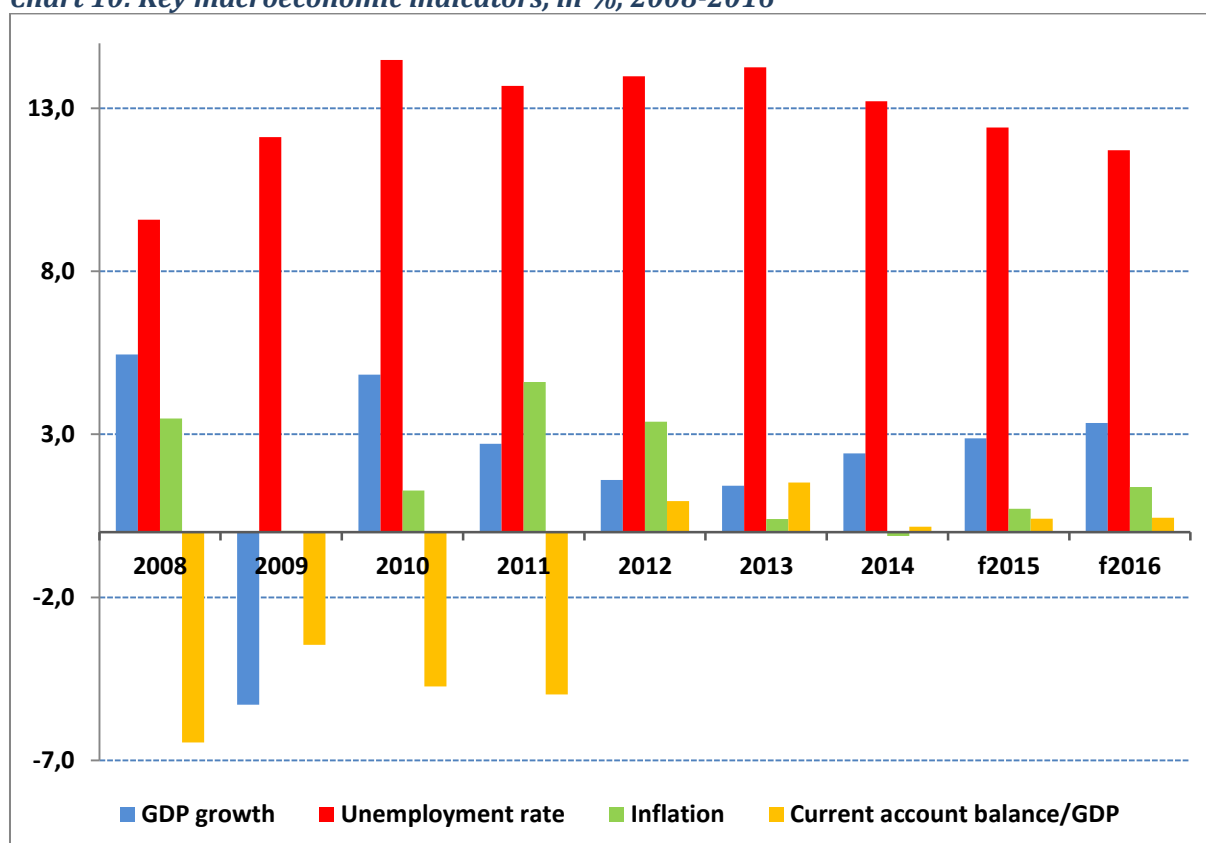
The economic growth of SR in the times of recessions (esp. y. 2009) was very specific: it has been accompanied with unfavourable development of domestic demand. Economic growth was connected with decrease of household consumption and was exceptionally dependent on growth of external demand – so, on the export. Weak domestic demand makes economic growth a vulnerable one. The share of export and also import of goods and services on GDP

increased to record values since 2010 to 2013, while export performance and also import intensity came close to 100 % of GDP.

Another negative factor of the period was the 2009 gas crisis between Ukraine and Russia (claimed losses of Slovak companies was 150 mil. EUR, however the total loss of the economy was more than 1 milliard EUR). Out of gas, the Slovak government decided in cold winter to protect inhabitants, so all companies that are using gas in the production had to stop its production for 2 weeks in January 2009. It resulted in dramatic fall of GDP in 1Q 2009: -5,4%, industrial production felt by 23%, construction by 13,6%, wholesale trade felt by 25%, export felt by 28,2%, rapid growth of unemployment to 11,1% (72 ths. new unemployed within first 5 months of the year).

Actions taken by Slovak government (increased EU funds drawing, PPP projects - roads, new nuclear plant), scrapping contribution for old cars, support for Exim bank and SQDB, supporting energy efficiency of companies and houses, increasing tax-less amount of income tax, shortening of VAT refund to 30 days, micro-loan program for SME etc.) tried to decrease the negative impact. There was also EUROzone membership effect: stable and predictable exchange rate, but huge shopping activities of inhabitants in neighbouring V4 countries that devaluated their currencies as one of the anti-crisis measures and also worsening the position of Slovak exporters on international markets.

Chart 10: Key macroeconomic indicators, in %, 2008-2016



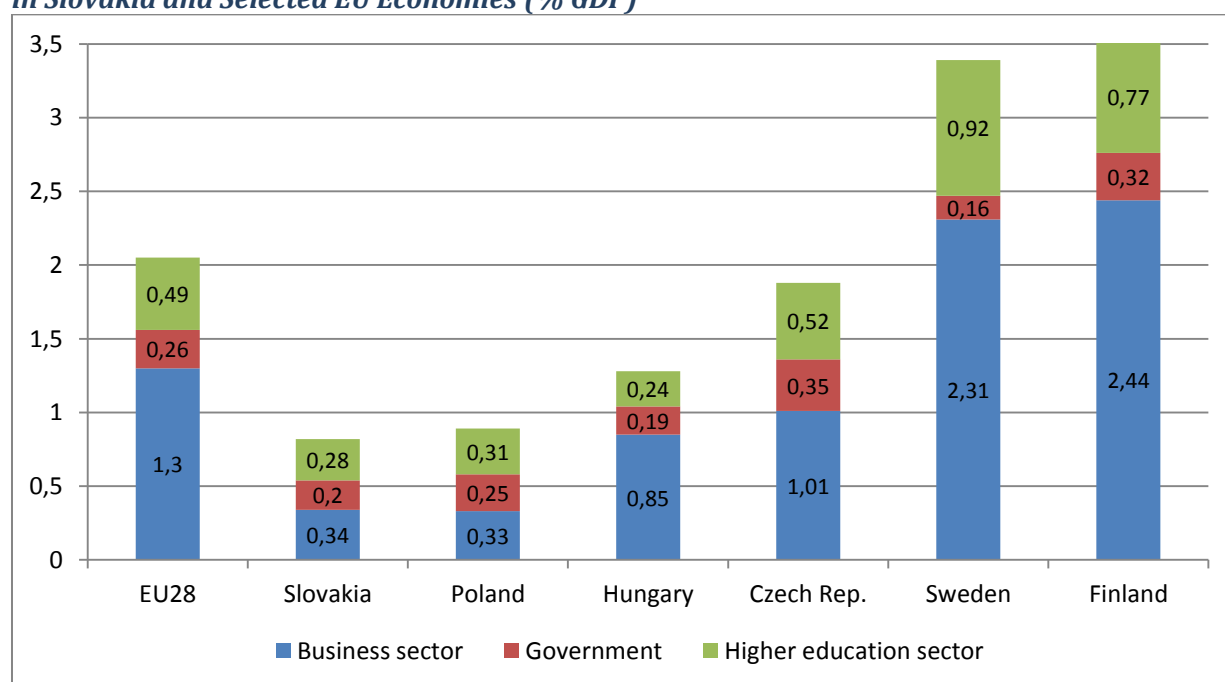
Source: Authors, data based on the IMF - The World Economic Outlook database (2015). Years 2015 – 2016 are IMF forecast.

In the period of 2009 – 2014, Slovakia started to use the available resources from EU Cohesion policy in more vivid manner (approximately 11.5 billion EUR was allocated for 2007-2013 period). Without EU funding, national regional policy would lack the necessary resources for

regional development. Especially in times of fiscal consolidation and impact of the global economic crisis, the Cohesion Policy provided significant amount of financial resources for regional development in all policy areas. The areas, which are benefiting from the progress in implementation of operational programmes are mainly transport infrastructure, research and development, environment, support of enterprises, healthcare and regeneration of public infrastructure. However, the financial implementation of Cohesion policy programmes is not optimal. Significant efforts are needed to fully utilise the potential of the financial resources allocated in the operational programmes to improve the absorption and more importantly to achieve the objectives.

Slovakia lags in total expenditure on R&D not only compared to innovative advanced small economics of the EU, but also to its neighbours (Poland, Czech Republic and Hungary).

Chart 11: Structure of Gross Expenditure on R&D in 2012 by Sector of Performance in Slovakia and Selected EU Economies (% GDP)



Source: Authors, based on Eurostat data (2015).

From innovative performance and its prerequisites point of view, there is continuous negative tendency in absolute and relative (number of patents per 1000 of R&D employees) patent performance. Patent performance measured by number of patent applications mildly decreased in 2012 to 223 domestic patent applications. That led to lower patent performance, which decreased from 8.4 in 2010 to 7.8 domestic patent applications per 1000 R&D employees. Lower patent performance is indicated by significant drop of Slovak patent applications in European Patent Office (EPO).

Table 4: Patents

	2007	2008	2009	2010	2011	2012
Domestic patent applications	240	167	176	235	223	168
Number of patent applications per 1,000 R&D employees	10.2	7.1	6.9	8.4	7.8	5.8
Number of EPO patent applications	44	54	41	53	85	51

Source: Patent Office of the Slovak Republic (2014).

Regional disparities – potential source of development problems in Slovakia

The last fifteen years have brought positive changes and economic growth across all Slovak regions, making Slovakia converge upon the EU countries average. However, the ratio of growth is influenced by north-eastern gradient, whilst Bratislava region belongs to the most progressively developing EU regions, Eastern Slovakia shows the slowest growth of all Slovak regions. Being compared to many other European regions, Eastern Slovakia growth is nevertheless positive.

Table 5: Comparison of GDP contribution per capita to EU28 countries average in %

Region NUTS 2 / year	1996	2000	2004	2007	2008	2009	2010	2011	Growth
Prague (CZ)	128	139	163	177	175	176	173	171	+43
Middle Moravia (CZ)	65	58	62	64	64	67	66	67	+2
Chemnitz (GE)	81	77	81	83	81	80	84	86	+5
Stuttgart (GE)	n.a.	143	139	141	142	133	145	152	+9
Észak-Magyarország (HU)	36	35	41	39	40	40	40	40	+4
Wien (AT)	n.a.	182	170	161	162	164	165	165	-17
Mazowieckie (PL)	n.a.	74	78	87	89	97	103	107	+33
Podkarpackie (PL)	34	34	35	37	39	41	42	44	+10
Malopolskie (PL)	n.a.	42	43	47	49	52	54	56	+14
Slaskie (PL)	n.a.	52	57	58	61	66	68	70	+18
Bratislava region	104	109	129	160	167	178	179	186	+84
Western Slovakia	48	47	54	66	69	68	69	72	+24
Central Slovakia	41	41	47	54	59	58	61	59	+18
Eastern Slovakia	38	38	42	46	51	49	50	51	+13

Source: Authors, calculation based on EUROSTAT (2015) statistics.

The regional disparities in Slovakia are characterised by a significant west – east and north – south divide, with the Bratislava region being the most developed region in terms of GDP per capita. The main factors underlying the existing regional disparities are the following:

- Lack of high quality transport infrastructure, low regional interconnection and accessibility.
- Institutional quality of regional and local administration.
- Low inter-regional as well as intra-regional mobility of labour force.
- Difficult access to affordable housing in areas providing employment opportunities.
- Environmental burdens related to previous heavy industrial activity.
- Low level of economic development in border regions, especially in the east and south of Slovakia – proximity to low developed regions of Ukraine, Poland and Hungary.
- Restructuring of “traditional” industry sectors.
- The quality of human resources (education attainment, entrepreneurial spirit).

Reasons why e.g. Eastern Slovakia lags behind vary. The first one reflects the territory character and location influencing the territory development for a long time. Until socialistic industrialisation, Eastern Slovakia used to be predominantly agricultural country without large or important industrial plants. Later the differences disappeared, but time showed that establishing large industrial plants to create employment for entire districts was a big disadvantage after transition to market economy. Moreover, Eastern Slovakia is typical of low density of large urban areas and disintegrated settlement structure created by a large number of small villages.

Another influential development element arises from melancholy character of the neighbouring countries' border regions. Those ones are the least developed regions of Hungary, Poland and Ukraine so their economic power, potential and cooperation have a very little capacity to be economic development stimuli. The existence of Schengen border as a considerable barrier, an eccentric, remote location and lack of transport infrastructure (logistic market connection) make Eastern Slovakia non-competitive and lagging behind.

The highest unemployment rate in Slovak Republic has been for last 2 decades in Banská Bystrica region, Prešov and Košice. In recent years, unemployment rate has been ranging from 17 % to 22 % on average in these regions. Unemployment rate in Prešov region reached 19.35 % in December 2013, the highest of all Slovak regions. Banská Bystrica region reached the rate of 18.26% and Košice region 17.23 %. They are the only three regions exceeding the entire Slovakia average of 13.50 % in December 2013.

The situation positively changed in 2014, while both regions – Košice and Prešov – experienced decrease of unemployment, mostly caused by positive economic development, new investment into the region and also by public works and employment measured taken by the government.

Table 6: Rate of registered unemployment (in %)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Slovak Republic	18.63	17.45	15.56	13.07	11.36	9.40	7.99	8.39	12.66	12.46	13.59	14.44	13.5	12.29
Eastern Slovakia	24.74	23.62	20.84	18.19	16.62	14.41	12.52	13.17	17.81	17.28	18.85	20.14	18.32	16.72
Prešov region	23.96	23.00	19.57	17.50	15.77	13.68	12.05	12.86	18.29	17.75	18.95	20.66	19.35	17.45
Košice region	25.55	24.26	22.16	18.89	17.5	15.18	13.02	13.50	17.30	16.78	18.76	19.58	17.23	15.92

Source: Statistical Office of the SR (2015).

Besides high unemployment rate, also a high proportion of long-term unemployed (more than a year) in the total number of unemployed is another negative fact. Long-term unemployed made up more than 53.6 % proportion of all registered unemployed in the SR in December 2013. Long-term unemployed proportion in Košice region is higher than the average in the SR, namely at the level of 60.8 %, in Prešov region as many as 61.1 %. From this point of view, higher attention to marginalised socially excluded population groups must be paid. Their inclusion in society (and mainly in labour market) is the most difficult long-term task especially in the regions of Košice, Prešov and Banská Bystrica where majority of them lives.

To change these negative tendencies, the productive capacity – both in industry and agriculture in the peripheral regions of the country – Eastern, Southern and Central – should be strengthened. This production would be primarily geared towards domestic, local markets.

Conclusion – lessons learned & prospects for future development

Although the transition of Slovakia, other Visegrad and post-communist countries towards the market economy represents a unique process, identification of its successful sides as well as problems and shortcomings may be useful for other transition processes, e.g in EaP countries. However, given the differences in initial conditions, in historical, political, economic and social background as well as in the final goals and character of reforms, it should be kept in mind that the story of economic transition of Slovakia from the centrally planned to the market economy,

with its positive as well as negative features, cannot serve as a pure guide for conducting any transition in any country.

Anyway, as has the Slovak experience with transition and EU accession shown, it is crucial to build functioning institutions, in particular the formal ones, already in the initial stage of any transition. In addition, both too slow and too fast implementation of reforms can result in a slow-down or even stoppage of the transition process. At the same time, the high speed of reforms should not be achieved at the expense of their quality and long term sustainability.

Moreover, the experience of Slovakia shows how markedly reform strategies and the parameters of adopted reforms are linked to the political cycle. The way of managing transition in Slovakia is characterised by several mistakes which resulted in economic losses as well as decreasing confidence in transition process. Transition process has created foundations of the market economy in Slovakia, however, its design is still not satisfactory. The global financial and economic crisis has revealed even more shortcomings of transition. Continual legislative and institutional changes and political controversies have been typical features of transition. The way of implementation of some welfare reforms makes their long term sustainability doubtful. Frequent changes of reforms, law amendments and sudden changes in the welfare system (e.g. the pension system reform in Slovakia) may increase fears about the final results of the reforms.

During transition, regional disparities in Slovakia have sharpened significantly, which has reflected in particular in increasing unemployment rate and growing number of receivers of social benefits. Long term unemployment as well as unemployment of young people has become a serious social problem. Long term unemployment raises the risk of permanent dependence on social benefits, the risk of falling into poverty and transfer of poverty to the next generations.

Nowadays, the Slovak economy, similarly as the whole Europe, faces another two transitions, namely transition towards knowledge based economy and transition towards low carbon economy. The future development of the Slovak economy will depend on a new set of reforms aimed at changes in the education system, R&D and innovation support, domestic SME support and implementation of extensive reforms in the public sector (especially the judiciary system and public administration).

The Slovak Republic's main economic challenges are:

- Come back to good, competitive business environment and reduce corruption
- Move to knowledge based economy
- Diversification of industry and export territories
- Increase the quality of education and life/long learning
- Increase the quality and quantity of R&D and need for higher interlacing with business sector
- Need to tackle long-term unemployment and need to come back to flexible labour market
- Need to deal with social exclusion (esp. minorities like Roma people)
- Reduce the impact of demographic tendencies (ageing)
- Energy security and others.

Furthermore, Slovakia needs to strengthen its domestic production base and expand its sources of growth. There is a need to boost employment, particularly long-term and youth employment. Improving workers' skills levels and labour market outcomes will require broadbased

education and up-skilling, labour market and tax reforms. There is a need to strengthen active labour market policies. Active labour market policies spending, which compares unfavourably with that in other EU countries, should be raised and its effectiveness improved through more tailored activation incentives and services as well as increasing the share of spending allocated to training. Strengthening jobseekers' activation, especially on training and job-search support, removing obstacles to labour mobility and encouraging female labour force participation would increase overall labour utilisation. Reducing barriers to competition, especially in non-manufacturing industries, and strengthening innovation and education outcomes would increase productivity. Activation programmes and more inclusive education policies would reduce income inequality by improving employability and integration of most vulnerable groups, in particular the Roma and youth. Those policies would also reduce the relatively high regional income disparity.

Slovakia needs to support new drivers of growth. Economy has relied to a large extent on foreign investment in low-value added, wage-cost sensitive and export-oriented activities. The objective for the Slovak Republic will be to diversify and upgrade its supply capacity which will ultimately require investments in skills and innovation. Low research and development (R&D) expenditure and innovation activity in the business sector constrain the capacity to adopt new technology and hamper productivity growth. It is important to strengthen the business climate and reduce regulatory barriers to competition. Slovakia's regulatory burden compares unfavourably with other EU countries. In addition, corruption challenges are perceived as widespread and have involved e.g. EU Funds. Strengthening contract enforcement (e.g., to address payment delays that particularly affect small firms), improving administrative procedures and public procurement, as well as enhancing the legal system and strengthening anti-corruption efforts would create more favourable conditions for doing a business.

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